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STAFF RECOMMENDATIONS TO REVISE SUBCHAPTER C

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

SEPTEMBER 30, 1985

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STAFF RECOMMENDATIONS TO REVISE SUBCHAPTER C

MONDAY, SEPTEMBER 30, 1985

U.S. SENATE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:39 a.m., in room SD-215, Dirksen Senate Office Building, Hon. John Chafee (chairman) presiding.

Present: Senators Chafee and Danforth.

[The press release announcing the hearing and background material on Tax Reform Proposals: Corporate Taxation and an opening statement of Senator Dole follow:]

[Press Release No. 85-056, Wednesday, July 17, 1985]

COMMITTEE ON FINANCE HEARING ON SUBCHAPTER C SCHEDULED FOR SEPTEMBER 30

Senator Bob Packwood (R-Oregon), Chairman of the Senate Committee on Finance, announced today that the Subcommittee on Taxation and Debt Management has scheduled a hearing on the staff recommendations to revise Subchapter C of the Internal Revenue Code that were submitted to the Committee this past May.

Chairman Packwood said that the Taxation Subcommittee's hearing is scheduled to begin at 9:30 a.m., Monday, September 30, 1985 in Room SD-215 of the Dirksen Senate Office Building.

Senator John Chafee (R-Rhode Island), Chairman of the Subcommittee on Taxation and Debt Management, will preside at the September 30 hearing.

The subject of the hearing will be a final staff report that recommended a number of significant revisions to Subchapter C. The report represented the culmination of over two and one-half years of study. A preliminary report was filed with the Committee in September, 1983, and hearings on the recommendations contained in the preliminary report were held in October, 1983.

"A great deal of time and study has already gone into the Subchapter C project," Chairman Packwood said. "I am hopeful that this hearing will provide good, constructive testimony that will help to shape any revisions to this important area of the law."

"It should also be noted that the staff proposals contain specific recommendations relating to the net operating loss rules," Chairman Packwood added. "At the end of this year, Congress, once again, will be faced with the question of whether to put into effect the 1976 version of Section 382. I hope that this hearing will help to clarify what course of action Congress should take in that difficult area:"

Chairman Packwood requested that witnesses include in their testimony comments on the following issues;

(1) The proposal to make corporate level tax consequences of a qualified acquisition explicitly elective;

(2) The proposed separation of shareholder level tax consequences from the corporate level election, and from the tax consequences to other shareholders;

(3) The proposed uniform definitional structure for "qualified acquisitions";

(4) The proposed complete repeal of the so-called General Utilities doctrine, assuming adequate relief is provided in appropriate circumstances;

(5) The various forms of relief from the repeal of the General Utilities doctrine that are proposed in the final staff report;

(6) Assuming any General Utilities relief should appropriately be limited to small business, should the relief follow along the lines of the final staff report recommendations, or is some alternative form of relief for small business preferable?

(7) Regarding net operating losses, the following questions should be addressed:

(a) Are the staff proposals preferable to the current law (1954 version) rules limiting net operating loss carryovers?

(b) Are the staff proposals preferable to the 1976 version of the rules?

(c) Are the staff proposals preferable to the so-called "two-rule" approach (i.e., a separate rule for "mergers" and for "purchases") or a single "merger" rule approach?

(d) Assuming a single "purchase" rule is to be adopted, is the proposed formula based upon the applicable long-term Federal rate the proper limitation rule?

(e) Should there be a special "investment company" rule along the lines of the staff proposals?

(f) Should built-in gains and losses be treated as proposed? How should built-in depreciation deductions be treated?

(g) What should be the proper role of Section 269 if the staff proposals are enacted? What should be the proper role of the special limitations contained in the consolidated return regulations, including the separate return limitations year (SRLY) and consolidated return change of ownership (CRCO) rules?

3

TAX REFORM PROPOSALS: CORPORATE TAXATION

For the Use

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

SEPTEMBER 19, 1985

INTRODUCTION

This pamphlet[1] is prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in connection with the respective committee review of comprehensive tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets. It describes and analyzes tax provisions and proposals relating to corporate taxation.

The pamphlet describes present law tax provisions and the tax reform proposal made by President Reagan ("The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), the 1984 Treasury Department report to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "Treasury Report"), Congressional proposals (identified by the primary sponsors), and other related proposals. Each part of the pamphlet includes an analysis of the tax-related issues.

The first part of the pamphlet is a discussion of corporate tax rates. Part two discusses the two-tier tax on distributed income and certain exceptions. Part three discusses distributions and liquidating sales of appreciated assets and the *General Utilities* doctrine. Part four discusses entity classification, and part five discusses certain other corporate issues.

Additional corporate tax proposals relating to mergers and acquisitions are discussed in two Joint Committee on Taxation staff pamphlets *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS 6-85), March 29, 1985; and *Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (and S. 420, S. 476 and S. 632)* (JCS 9-85), April 19, 1985. Proposals relating to corporate net operating loss carryovers are discussed in a Joint Committee on Taxation staff pamphlet, *Special Limitations on the Use of Net Operating Loss Carryovers and Other Tax Attributes of Corporations* (JCS 16-85), May 21, 1985.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Corporate Taxation* (JCS-40-85), September 19, 1985.

I. CORPORATE TAX RATES

Present Law and Background

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The top corporate tax rate is 46 percent on taxable income over $100,000.

The corporate taxable income brackets and tax rates are presented in the following table:

Taxable income	*Tax rate*
Not over $25,000	15
Over $25,000 but not over $50,000	18
Over $50,000 but not over $75,000	30
Over $75,000 but not over $100,000	40
Over $100,000	46

This schedule of corporate tax rates, which reduced the previously applicable rates for up to $50,000 of taxable income, was enacted in the Economic Recovery Tax Act of 1981 (ERTA), effective for 1983 and later years. For 1982, the applicable rates were 16 percent for taxable income not over $25,000, and 19 percent for taxable income over $25,000 but not over $50,000. For taxable years after 1979 and before 1982, the rates were 17 percent and 20 percent, respectively.

An additional 5-percent corporate tax is imposed on a corporation's taxable income in excess of $1 million. However, the maximum additional tax is $20,250. Thus, the benefit of the graduated rates is eliminated for corporations with income in excess of $1,405,000. This provision was enacted in the Deficit Reduction Act of 1984, effective for taxable years beginning after 1983.

Rules are provided to prevent the proliferation of the benefits of the graduated rates through the use of commonly controlled multiple corporations (secs. 1551, 1561-1564).

Other statutory provisions attempt to limit the use of corporations to avoid the individual tax rates. These are principally the accumulated earnings tax (secs. 531 *et. seq.*), the personal holding company tax (secs. 541 *et. seq.*), and certain personal service corporation provisions (sec. 269A).

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax (sec. 1201).

Administration Proposal

Under the Administration proposal, tax would be imposed on corporations under the following schedule:

Taxable income	*Tax rate*
Not over $25,000	15
Over $25,000 but not over $50,000	18
Over $50,000 but not over $75,000	25
Over $75,000	33

The graduated rates would be phased out for corporations with taxable income over $140,000. Corporations with taxable income of $360,000 or more would pay, in effect, a flat tax at the 33 percent rate.

The alternative tax for net capital gains of corporations would remain at 28 percent.

The proposed tax rates would be effective July 1, 1986. Thus, the rate schedule for taxable years including July 1, 1986 would reflect blended rates based on the new rates effective on such date (*see* sec. 15).

Other Proposals

1984 Treasury Report

The 1984 Treasury Report would replace the present graduated corporate rate schedule with a single 33 percent rate on corporate income. The Treasury Report would repeal the current provisions concerning multiple related corporations and domestic personal holding companies.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would replace the present law rate schedule with a single 30 percent rate on corporate income (the same as the top individual rate). This bill would repeal the current provisions concerning multiple related corporations, personal holding companies, personal service corporations, and the accumulated earnings tax. The bill would repeal the preferential rates for net capital gain.

H.R. 2222 and S. 1006 (Kemp-Kasten)

Under the Kemp-Kasten bill, income of large corporations generally would be taxed at a 35 percent rate. However, for corporate income under $100,000, graduated rates would apply. The first $50,000 of corporate income would be taxed at a 15 percent rate, and the second $50,000 would be taxed at a 25 percent rate. This rate reduction would save corporations with $100,000 of taxable income a total of $15,000 of tax (i.e., the difference between $35,000, the tax liability at a 35 percent rate, and $20,000, the tax liability at the proposed graduated rates). The benefit of graduated rates would not be phased out as under present law. For corporations electing capital gains treatment (rather than ordinary income treatment with basis indexed for inflation) the corporate capital gains rate would be 20 percent.

Analysis

The Administration proposal would retain a graduated rate structure for lower income corporations. The proposal states that adoption of a flat corporate rate (as proposed in the 1984 Treasury Report) would result in a substantial tax increase for low income corporations even though large corporations would benefit from a rate cut.[1a] The proposal seeks to retain some rate cut benefit for smaller as well as larger corporations.

The present law graduated rates for lower income corporations are intended to encourage growth in small business by easing the tax burden on such businesses.

Some argue that there is no economic rationale for retaining lower rates for low-income corporations. They contend that the ability-to-pay concept underlying the progressive individual rates is not applicable to corporations because corporate income is used for reinvestment or payment of dividends rather than for direct individual consumption needs. They also argue that the graduated rate structure may discourage mergers of small corporations that potentially could exploit economies of scale and raise productivity. Some also contend that owners of small corporations are in many cases relatively affluent individuals who may be better off having income taxed at lower corporate rates than at their regular individual rates, and that small corporations with 35 shareholders or less may elect to be taxed as an S corporation, in which case there is no corporate-level income tax and corporate income is taxed directly to the shareholders at their tax rates.

The availability of the graduated corporate rates and of a top corporate rate lower than the top individual rate has made it necessary to provide complex rules to prevent the proliferation of low tax brackets through the use of commonly controlled multiple corporations and to maintain certain sets of rules aimed at preventing the use of corporations to avoid the individual tax rates. These latter provisions, especially the personal holding company tax, were originally enacted in large part to prevent individuals from avoiding the individual rates at a time when the top individual rates were substantially higher than the corporate rates. Under present law, the top individual rate is 50 percent and the top corporate rate is 46 percent. Under the Administration proposal, the top individual rate is 35 percent and the top corporate rate is 33 percent. Use of the graduated corporate rates by individuals in the top income tax bracket could produce additional tax savings to the extent of undistributed corporate income. A main function of provisions such as the personal holding company tax under the Administration proposal would be to limit such use of the graduated corporate rates.

The 1984 Treasury Report would have contained the same two point differential in the top individual and corporate rates as does the Administration proposal, but did not provide graduated corporate rates and would have repealed the personal holding company tax.

[1a] Under the 1984 Treasury proposal, the tax rate applicable to corporations with taxable income below $155,770 would increase, while the tax rate applicable to corporations with income equal to or greater than $155,770 would decrease.

Some have suggested providing a top corporate rate equal to the top individual rate. Others contend that a lower top corporate rate is appropriate to relieve double taxation of corporate income (see Part II, infra). Some suggest that the benefit of favorable corporate rates could be used as an incentive to certain goals. For example, proponents of broader employee ownership of corporations have suggested favorable lower rates for corporations with a specified percentage of employee ownership, or with progressively increasing employee ownership, as one of several possible incentives.[2]

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[2] See separate Joint Committee on Taxation staff pamphlet, *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* September 1985.

II. THE TWO-TIER TAX ON DISTRIBUTED INCOME AND CERTAIN EXCEPTIONS—PROPOSALS REGARDING DIVIDEND DEDUCTIONS

Present Law and Background

In general

Under present law, corporations and their shareholders generally are separate taxable entities. A corporation's taxable income is subject to a corporate income tax at graduated rates with a maximum 46 percent rate for taxable income exceeding $100,000. Distributions by a corporation to its individual shareholders, to the extent of the corporation's current and accumulated earnings and profits,[3] generally are taxable as ordinary income to the shareholders, at graduated rates up to 50 percent.[4] Thus, corporate income that is distributed to shareholders generally is subject to two tiers of tax.

In contrast, corporate income that is not distributed to shareholders is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at favorable capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation. If an individual shareholder retains stock until death, the appreciation can pass to the heirs free of income tax (sec. 1014).[5]

Various deductions and credits can reduce or eliminate the corporate level tax. Corporate income distributed as interest payments to creditors rather than as dividends to shareholders is not taxed at the corporate level, since the corporation generally may deduct interest payments (but not dividend payments) from its taxable income.

The deductibility (within reasonable limits) of funds paid as salaries to shareholders who are also employees, reduces corporate tax and involves current taxation of the payment to the shareholder.[6]

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[3] Earnings and profits (sec. 312) are a measure of a corporation's economic income that frequently exceeds a corporation's taxable income. See discussion of earnings and profits in Part V., *infra*.

[4] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock and accordingly may be taxed to the shareholder at capital gains rates.

[5] In addition, in the case of certain corporate distributions in liquidation or in certain redemptions, unrealized appreciation in corporate assets can escape corporate tax entirely (apart from the recapture of specified items, such as certain prior depreciation deductions). In such cases, only a capital gains tax at the shareholder level may be imposed on the appreciation when the assets are distributed to the shareholders or sold to a third party and the proceeds distributed. The absence of taxation at the corporate level in these circumstances is discussed in Part III, below.

[6] It is possible that salaries of some shareholder-employees may be inflated to some extent within a range of asserted reasonableness, leaving little or no reported taxable income at the corporate level.

Other provisions that may affect corporate taxable income include preferential accounting methods and tax preferences under the Code that are intended as investment incentives, such as the investment tax credit, accelerated depreciation, and the exemption of interest on State and local obligations. Utilization of such provisions can reduce or eliminate the corporate level tax without requiring distributions to shareholders or otherwise resulting in current recognition of the income at the shareholder level. Corporations are subject to an "add-on" minimum tax on certain tax preferences.[7]

Certain Code provisions are designed to prevent unreasonable accumulations of corporate earnings (sec. 531 *et seq.*) or to cause the distribution of corporate earnings of "personal holding companies" to shareholders (sec. 541 *et seq.*). However, the provisions relating to unreasonable accumulations generally depend upon taxable income (with certain adjustments) and thus do not affect accumulations when a corporation is able to reduce its taxable income with certain preference items such as accelerated depreciation. The provisions intended to cause distributions of personal holding company earnings also generally depend upon taxable income and further apply only to certain closely held corporations that derive a substantial portion of their income from generally passive investments or certain personal services provided by shareholders.[8]

Exceptions

There are several departures in present law from this general scheme of corporation and shareholder taxation. Certain corporations are given direct relief from the corporate tax. Relief from taxation at the shareholder level is given in certain circumstances.

Relief from the corporate level tax

In general, direct relief from the corporate income tax is given to income earned by corporations electing under subchapter S ("S Corporations"), regulated investment companies ("RICs") (such as mutual funds), and real estate investment trusts ("REITs").[9] Income earned by an S corporation is allocated among and taxed directly to its shareholders regardless of whether such income is distributed. Income earned by a RIC or a REIT is subject to a tax at the corporate level, but both RICs and REITs are permitted deductions for dividends paid, in effect eliminating the corporate tax on earnings that are distributed. Moreover, in order to maintain their status as a RIC or a REIT, such entities are required to distribute most of their income currently.

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[7] The corporate minimum tax is discussed in a separate pamphlet, Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985.

[8] The Internal Revenue Service has ruled that certain corporate income from shareholder personal services is not subject to personal holding company tax, even though the client or customer may expect only the shareholder to perform the service, if someone else might theoretically be called upon to perform it. *See* Rev. Rul. 75-67, 1975-1 C.B. 169; Rev. Rul. 75-250, 1975-1 C.B. 172. A corporation earning only such income from the performance of services by its shareholders (for example, a professional corporation whose business consists of a shareholder performing medical services) could earn income subject to the graduated corporate rates and generally could accumulate a total of at least $150,000 without being subject to the accumulated earnings tax.

[9] S corporations are corporations that meet restrictions on the number of shareholders and certain other requirements and that also elect special treatment under Subchapter S. RICs and REITs are entities that derive a substantial portion of their income from essentially passive investments and that absent special provisions in the Code would otherwise be taxed as ordinary corporations. These entities are discussed further in Part IV below.

Direct relief from the corporate tax is also granted to cooperatives subject to subchapter T of the Code. In general, such cooperatives are also subject to tax at the corporate level but are given deductions for dividends paid out of profits derived from transactions with their members. Additionally, a cooperative may exclude income attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates.

Only amounts paid within 8-1/2 months of the close of the cooperative's taxable year are entitled to this special treatment. As a result, cooperatives generally pay corporate tax only on profits that are not distributed, and on profits not derived from transactions with members.[10] Cooperative members who receive dividends will treat the dividends as income, reduction of basis, or some other characterization that is appropriate based on the nature of the members' transactions with the cooperative.[11]

Additionally, certain dividends paid with respect to stock held in an employee stock ownership plan and distributed to plan participants are deductible by the corporation (sec. 404(k).[12]

Common to these areas of direct relief from the corporate income tax generally is a concept of current taxation at the shareholder (or member) level of income that is not taxed to the corporation.

Relief from the shareholder level tax

Individual shareholders.—Under present law, the first $100 of qualified dividends received by an individual shareholder ($200 by a married couple filing jointly) from domestic corporations is excluded from income (sec. 116). Thus, to this limited extent, distributed corporate earnings are subject to tax at the corporate level only.

The dividends exclusion for individuals does not apply to dividends received from a tax-exempt organization (under section 501), a farmer's cooperative, a REIT, or a mutual savings bank (that received a deduction for the dividend under section 591), or to an ESOP dividend for which the corporation received a deduction. The exclusion is limited with respect to dividends received from a RIC.

Under the Economic Recovery Tax Act of 1981, a limited amount of dividends in the form of stock of certain public utility corporations, paid prior to January 1, 1986, are exempt from shareholder tax; absent this special rule, such dividends would otherwise be taxable because the shareholder has elected to receive the stock instead of other property (sec. 305(e)). In effect, such amounts are not subject to shareholder tax if reinvested in the corporation.[12a]

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[10] In addition, tax-exempt farmers' cooperatives qualifying under section 521(b) of the Code may may receive additional relief from the corporate level tax since they may deduct patronage dividends paid to the full extent of their net income and also may deduct, to a limited extent, dividends on common stock.

[11] In some instances, cooperatives may operate on a "federated" basis, i.e., local cooperatives are patrons of other cooperatives operating on a regional or national basis. These cooperatives (and their individual patrons) may have different taxable years. This fact combined with the rule permitting patronage dividends to be deducted if paid within 8-1/2 months after close of a cooperative's taxable year can result in patronage earnings being distributed to a lower-tier cooperative and subsequently to an individual patron (generally the only party who is taxed on the income) in a taxable year subsequent to the year in which the income is earned.

[12] Employee stock ownership plans are discussed in a separate pamphlet prepared by the staff of the Joint Committe on Taxation.

Corporate shareholders.—Under present law, subject to certain exceptions, corporate shareholders receiving dividends generally are entitled to a deduction of 85 percent of the dividends received (sec. 243). Under the present 46 percent maximum regular corporate tax rate, the deduction means that the maximum corporate rate on dividends received from another corporation is 6.9 percent (.46 x (1-.85)). Dividends received from certain members of an affiliated group are eligible for a 100 percent dividends received deduction. In addition, pursuant to Treasury regulations, dividends received by one member of an affiliated group filing a consolidated return from another member of the group are not taxed currently to the recipient.

However, dividends received from another member of a consolidated group from pre-affiliation earnings and profits (deemed reflected in basis) or from post-consolidation earnings and profits that have increased the basis of the parent corporation's stock in the subsidiary, reduce the basis of the recipient corporation's stock in the payor subsidiary. (Treas. Reg. sec. 1.1502-32.)

In addition, any corporate shareholder's basis in shares with respect to which an "extraordinary dividend" was received may be reduced by the amount of the dividend that was not taxed unless the stock has been held for more than one year (sec. 1059). An "extraordinary dividend" is a dividend exceeding 10 percent of the basis of such common stock with respect to which the dividend was paid, or 5 percent of the basis of such preferred stock. Certain dividends are aggregated for this purpose.

The dividends received deduction is available whether or not the dividends represent earnings that were taxed to the the distributing corporation.

The dividends received deduction does not apply to certain dividends, including dividends received from a REIT, and the availability of the dividends received deduction is limited with respect to dividends received from a RIC.

The dividends received deduction is also not available with respect to dividends received on stock that is not held (with a substantial risk of loss) for a specified period, generally more than 45 days (90 days in the case of certain preferred stock)(sec. 246). The deduction is also limited for dividends received on certain "debt-financed portfolio stock" (sec. 246A).

International aspects

Dividends paid by a U.S. corporation to foreign shareholders generally are subject to a 30-percent withholding tax (secs. 1441, 1442) and may be subject to tax in the recipient's country as well.[13] Var-

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[12a] However, stock received as an untaxed dividend under section 305(e) is treated as having a zero basis. Moreover, a shareholder who disposes of any stock of the distributing corporation within a year of the record date of such a distribution is treated as having disposed of the stock received as a dividend and the disposition is ineligible for capital gains treatment.

[13] Certain dividends from a U.S. corporation that earns less than 20 percent of its gross income from U.S. sources (an "80-20 company") are not subject to U.S. tax when paid to foreign shareholders (secs. 861(a)(2)(B), 871(a) and 881; Treas. Reg. sec. 1.881-2). The Administration proposal would eliminate this rule. The foreign tax aspects of the Administration proposal are dis-

Continued

ious income tax treaties substantially reduce the rate of the U.S. withholding tax, however.

In the case of foreign investment in U.S. corporate equity, corporate income is taxed at the corporate level (by the United States) and, on distribution, at the shareholder level (by the United States and perhaps another country), thus generally producing a two-tier tax on corporate income.

In general, dividends received by a U.S. corporation from a foreign corporation are not eligible for the dividends received deduction, even though the foreign corporation may have paid U.S. tax. However, where at least 50 percent of a foreign corporation's gross income is effectively connected with a U.S. trade or business, a portion of the dividends paid by such corporation to a U.S. corporate shareholder is eligible for the dividends received deduction. That portion generally is based on the percentage of the foreign corporation's income that is effectively connected with its U.S. trade or business (sec. 245).

Administration Proposal

In general

Under the Administration proposal, a domestic corporation would be entitled to a deduction equal to 10 percent of the dividends paid from earnings that have borne the regular corporate tax. The deduction would not be available to corporations that otherwise are subject to special tax regimes, e.g., regulated investment companies and real estate investment trusts.

Distributions that are not treated as dividends would not be eligible for the deduction. However, distributions that are not dividends in form but are so treated for income tax purposes (e.g., certain pro rata stock redemptions) would be eligible for the deduction. In addition, the dividends received deduction for corporations would be changed from the present law 85 percent or 100 percent based on the degree of stock ownership, to 90 or 100 percent based on whether or not the payor is entitled to the dividends paid deduction (without regard to the degree of stock ownership).

Under the Administration proposal, the dividends paid deduction would be treated like an ordinary business deduction for the purpose of determining the corporation's income tax liability, including the liability for estimated tax payments.[14] Net operating losses attributable to the dividends paid deduction would be available to be carried back and forward to the extent permitted by present law.

The qualified dividend account

Under the Administration proposal, which would generally be effective on January 1, 1987, dividends would be eligible for the dividends paid deduction only to the extent that such dividends do not

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cussed in a separate pamphlet, Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers* (JCS-25-85), July 18, 1985.

[14] The Administration proposal does not discuss the effect of the dividends paid deduction on a corporation's earnings and profits. It would appear that the amount of the dividends paid deduction should not itself reduce earnings and profits, which would be reduced by the full amount of a dividend, whether or not deductible.

exceed the amount of a "Qualified Dividend Account" ("QDA"). Generally, the QDA consists of the amount of corporate earnings that have been subject to the corporate tax for taxable years beginning after 1986, less the amount of deductible dividends paid. Dividends paid after 1986 in taxable years beginning before 1987 would be treated for purposes of the deduction as having been paid during the first taxable year beginning after 1986.[14a]

Accordingly, each year a corporation would add to its QDA its taxable income (i.e., gross income less deductible expenses), subject to certain adjustments.[15] For this purpose, taxable income would not include amounts on which no corporate tax was paid as a result of any available credit (including the foreign tax credit).

For example, suppose a U.S. corporation had $200,000 of gross income from operations, $100,000 of deductions, and $50,000 of tax-exempt interest income. Some or all of the deductions may be attributable to tax preference items that grant tax deductions in excess of economic expense. The corporation's initial tax liability (assuming a flat 33 percent rate for ordinary income) would be $33,000 (i.e., net taxable income of $100,000 times 33 percent). Assume the amount of tax it ultimately pays is $17,000 after applying a $10,000 investment tax credit and a $6,000 foreign tax credit. The corporation would add $51,515 to its QDA, an amount which is equal to the $100,000 total of the corporation's taxable income less the amount that if granted to the corporation as a deduction would yield the same tax benefit as the $16,000 in credits that the corporation used to reduce its tax liability (i.e., $16,000 divided by .33).

The amount of dividends paid in a taxable year would be deducted from the balance of the QDA as of the end of the taxable year, except to the extent that the balance in the QDA would be reduced below zero. Dividends in excess of the QDA as of the end of the taxable year in which the dividends were paid would not be deductible. Moreover, such "excess dividends" could not be carried forward and deducted after amounts were added to the QDA in subsequent years. Appropriate rules would provide for the treatment of the QDA in merger or acquisition transactions.[16]

Nondividend distributions

Whenever a transaction is treated as a dividend for Federal income tax purposes, the corporation would generally be entitled to a deduction and required to adjust the QDA to the same extent as if an actual dividend distribution were made. Thus, for example, for purposes of the dividends paid deduction, the corporation generally would be treated as having made dividend distributions to the extent that certain redemptions (sec. 302), certain stock purchases by a related corporation (sec. 304), certain redemptions of preferred stock (sec. 306), and certain distributions of boot in reorganizations (sec. 356) are treated as dividends.

[14a] For example, if a corporation that uses a fiscal year deduction ending June 30 pays dividends on January 1, 1987, dividends would be eligible for the dividends paid only to the extent of income added to the QDA for corporation's fiscal year ending June 30, 1988.

[15] For this purpose, corporate income added to the QDA would be computed without regard to the dividends paid deduction in order to reflect the earnings available for distribution. The treatment of the dividends received deduction for this purpose is discussed under "Treatment of intercorporate distributions", *infra*. *See* n.19, *infra* regarding certain retroactive adjustments to taxable income such as net operating loss carrybacks or audit adjustments.

[16] The Administration proposal does not discuss such rules. Presumably, the QDA in this case could be treated as a "tax attribute" that is carried over in accordance with the provisions of section 381 It is unclear whether there would be a need for special limitations similar to those of section 382 to prevent trafficking in QDA's.

To be permitted to take the deduction, however, the corporation must treat the distribution as a dividend for information reporting purposes. Where any such transaction is not initially treated as a dividend but is later so characterized, the Internal Revenue Service would be authorized to allow the deduction, provided the corporation and the shareholder treated the deduction consistently.

Appropriate adjustment to the QDA would be made for certain nondividend distributions. In the case of complete liquidations, the QDA would be eliminated completely.[17] In the case of redemptions or partial liquidations, the QDA would be reduced proportionately with the amount of stock redeemed or portion of the stock liquidated, but not in excess of the amount of redemption or liquidation proceeds distributed to shareholders. This is analogous to the treatment under present law of the earnings and profits account upon redemptions or partial liquidations.

Treatment of intercorporate distributions

Under the Administration proposal, a corporation would be entitled to the 10 percent dividends paid deduction without regard to whether the shareholder-payee is an individual or a corporation.

Where a corporate shareholder receives a dividend with respect to which the payor corporation is entitled to a dividends paid deduction, such shareholder would be entitled to a 90-percent dividends received deduction. Although the corporate recipient generally would be taxed on only 10 percent of the dividends it receives, it would increase its QDA by the full amount of any such dividends. Thus, on redistribution of that amount to its shareholders, it would in turn be entitled to the 10-percent dividends paid deduction.

Where a corporate shareholder receives a dividend with respect to which no dividends paid deduction was available (because the distributing corporation did not pay any corporate tax on the distributed earnings), such shareholder would be entitled to a 100-percent dividends received deduction.[18]

The extent of the shareholder's ownership of the distributing corporation would not affect the amount of the dividends received deduction as it does under present law.

Under the Administration proposal, corporate earnings would be taxed no more than once prior to distribution to non-corporate shareholders.

To implement these rules, the payor corporation would be required to report to its corporate shareholders the amount of the dividends paid to such shareholders with respect to which a dividends paid deduction was allowed to the payor corporation.[19]

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[17] The Administration proposal does not discuss whether this treatment would apply to liquidations of controlled subsidiaries qualifying for nonrecognition treatment under section 332. A corporation's QDA in this situation could be treated as a "tax attribute" that is carried over to the shareholder corporation under section 381. *See* n.16, *supra*.

[18] The Administration proposal does not directly address the treatment of the recipient corporation's QDA in the case of dividends eligible for the 100 percent dividends received deduction. It would appear that there should be no adjustment to the recipient's QDA on account of such dividends paid out of untaxed income (i.e., neither the dividend nor the deduction should be reflected in the QDA). Otherwise, the recipient would build up its QDA with respect to amounts that have borne no corporate tax at any level.

The Administration proposal would not alter any of the provisions of current law that deny the dividends received deduction in certain circumstances (e.g., sec. 246). Accordingly, in such circumstances, the full amount of the dividend would be taken into account in computing the recipient corporate shareholder's taxable income, no dividends received deduction would be allowed to the shareholder and no special rules would be used to compute the shareholder's QDA. The payor corporation, if otherwise eligible, could obtain the 10 percent deduction for the dividend paid.

Treatment of foreign corporations and foreign shareholders

Under the Administration proposal, a U.S. corporation would be entitled to the dividends paid deduction without regard to whether the dividends were paid to domestic or foreign shareholders. However, those foreign shareholders who do not benefit from a treaty entitling them to a limitation on the U.S. dividend withholding rate would be subject to an additional withholding tax on dividends from a U.S. corporation. The additional tax would equal the benefit received by the U.S. corporation on account of the dividends paid deduction. Thus, there would be imposed an additional withholding tax equal to 3.3 percent of the amount of dividends with respect to which a dividends paid deduction was allowed.[20]

At least initially, the additional withholding tax would not be imposed on dividends paid to foreign shareholders entitled to a maximum withholding rate on dividends under a treaty. All U.S. income tax treaties presently in force establish such a maximum rate of tax. However, authority would be reserved for the Treasury Department to impose the compensatory withholding tax on dividends paid to shareholders in any treaty country that grants relief from a domestic two-tier tax to its national shareholders but not to U.S. shareholders.

Under the Administration proposal, the dividends paid deduction would be allocated between U.S. and foreign source income. The proposal states that the allocation to a particular source would be proportionate to the amount of earnings from the particular source in the QDA out of which the dividend was paid.

A foreign corporation would not be entitled to the dividends paid deduction under the Administration proposal. However, the dividends received deduction allowable under present law with respect to dividends received by a domestic corporation from a foreign corporation's earnings subject to U.S. corporate income tax would be increased to 100 percent of such dividends received.

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[19] The Administration proposal does not discuss the effect of net operating loss carrybacks or other subsequent year adjustments (such as audit adjustments) that may retroactively reduce (or increase) the QDA and eliminate (or create) a payor corporation's dividends paid deduction. Such adjustments could retroactively affect a recipient corporation's dividends received deduction. Appropriate rules would have to be developed to address this situation, taking into account administrative difficulties that may arise if payor corporation adjustments would require adjustments to the tax liability of all recipient corporations.

[20] The benefit of the deduction to the corporation equals 10 percent of the dividend times the 33 percent corporate rate, or 3.3 percent of the dividend.

Treatment of individual shareholders

Under the Administration proposal, the limited dividends received exclusion for individuals would be repealed.

Other Proposals

Several alternatives might be considered as a means of lessening or eliminating the burden of the two-tier taxation of income earned by corporations.

1984 Treasury Report

The 1984 Treasury Report proposed a dividends paid deduction and a corresponding dividends received mechanism generally similar to that in the Administration proposal, except that 50 percent rather than 10 percent of dividends paid would have been eligible for the deduction.

Shareholder credit

An alternative to a dividends paid deduction is a mechanism that would give shareholders an income tax credit to reflect all or a portion of the corporate level tax paid with respect to the dividends received. The amount of the credit could be adjusted based on the degree to which partial relief from the two-tier tax is desired.[21] Under such a system, shareholders who receive dividends could "gross up" the dividends by the amount of the credit for corporate taxes paid, and include the grossed-up amount in income while using the credit as an offset to their tax liability.

Credit systems, also known as "imputation systems," are used by several foreign countries including West Germany, France, Canada, Japan, and the United Kingdom. A number of these countries grant the shareholder credit only to the extent the corporation has actually paid tax on dividends.

An approach involving a nonrefundable shareholder credit was proposed by Chairman Ullman of the House Committee on Ways and Means in 1978.[22]

Full integration: Deemed distribution and reinvestment of corporate earnings

Relief from the two-tier tax also could be achieved by eliminating the corporate level tax but allocating undistributed earnings currently among the shareholders. Under this approach, a corporation's undistributed earnings would be deemed to have been distributed to and reinvested by the shareholders each year. Tax could be collected at the corporate level, in effect using the corporation as a withholding agent for the shareholders, or tax could be collected solely at the shareholder level without withholding. Shareholders would be subject to income tax on the allocated earnings and would adjust their basis in their shares accordingly.

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[21] Like the dividends paid deduction, the mechanism for implementing a shareholder credit system could be designed to ensure that the credit is available only with respect to corporate earnings that have been taxed. *See* the discussion under "Treatment of tax preference items", *infra*.

[22] *See* 124 Cong. Rec. H2337 (March 22, 1978).

In one form of this mechanism, all corporations could be treated in a manner similar to either partnerships or S corporations; this treatment could include the passing through of credits and losses. Other versions could provide for the passthrough of net income but not losses in excess of income, as is the case with REITs. This form of relief from the two-tier tax is known as "full integration" since the separate corporate level tax is eliminated with respect to all corporate earnings, rather than distributed earnings only.

Lowering corporate taxes

Lowering corporate taxes, either by lowering corporate taxes generally or by granting or increasing certain preferences, has been suggested as possible means of reducing the burden of the two-tier tax on corporate income.

ALI Reporter's Study

A *Reporter's Study on Corporate Distributions* was published as an Appendix to the American Law Institute's *Federal Income Tax Project, Subchapter C, Proposals on Corporate Acquisitions and Dispositions* (1982).[22a] The Reporter's study made three specific proposals relating to the two-tier taxation of corporate income. The proposals would (1) provide a deduction for dividends paid on new corporate equity, (2) impose a compensatory excise tax on nondividend distributions, and (3) modify the tax treatment of intercorporate investment and distributions.

The Reporter's first proposal would permit a corporation to deduct dividends allocable to new equity (i.e., shares issued after the proposal becomes effective) generally to the same extent that distributions would have been deductible if debt instead of equity were issued. The corporation would apply an assumed rate of interest to the amount of new equity raised and a deduction would be permitted for dividends paid up to this amount (even though paid to old as well as new shareholders). At the same time, the deductions for interest on new debt from 10 percent or greater shareholders generally would be limited to the same assumed rate utilized in computing the dividend deduction. By focusing on new equity only, this proposal attempts to lessen any bias in favor of new debt financing over new equity, while limiting the revenue impact and potential redistributional effect of dividend relief on all preexisting equity.

The Reporter's second proposal would, in general, impose a compensatory excise tax on corporations making nondividend distributions in excess of amounts of new equity capital raised. The excise tax would compensate for the fact that in nondividend distributions (generally taxed to shareholders at preferential capital gains rates or as a tax-free recovery of basis), assets have been freed from the burden of the corporate tax without having borne tax at ordinary income rates at the shareholder level. The Reporter's study notes that such distributions are the economic equivalent of dividend distributions followed by the purchase and sale of shares among shareholders. Limiting the excise tax to nondividend distributions in excess of new equity capital is intended to be consistent with the first proposal in treating new equity and debt similarly.

[22a] The proposals contained in the Reporter's Study have not been adopted by the American Law Institute.

The Reporter's third proposal would distinguish between a corporate shareholder's portfolio and direct investments. Any investment in a majority of the common stock of an issuer for a year would be a direct investment; any investment in 10 percent or more of the common stock of an issuer could electively be designated as a direct investment; other investments would be portfolio investments. The proposal would deny a corporate shareholder deductions for dividends received on portfolio investment. Payment for the corporate acquisition of any direct investment (which could still qualify for the deduction) would be treated as a nondividend distribution subject to the excise tax imposed by the second proposal. The proposal notes that such acquisitions could have an effect comparable to redemptions, i.e., the distribution of corporate earnings outside of a corporation without being taxed as dividends.[23] The proposal would also deny a corporate shareholder deductions for dividends received on a direct investment until the time at which the dividends were redistributed.

Modification of the dividends received deduction

Whether or not a dividends paid deduction is implemented, certain modifications to the dividends received deduction (other than those contained in the Administration proposal) could be made. The most extreme option would be the elimination of the deduction (subject to appropriate transition rules). A somewhat less extreme option (as proposed by in the Reporter's Study Appendix to the ALI Subchapter C Proposals) would be elimination of the deduction for portfolio investment. Another option would be limiting the dividends received deduction to dividends that are paid out of earnings that have been subject to corporate tax. Others have suggested allowing the deduction for the lesser of dividends received or paid by the corporation during the year.[24]

Some have suggested requiring a recipient corporation to reduce its basis in the stock of a distributing corporation by the amount of dividends excluded from the recipient's income because of the dividends received deduction, or possibly requiring reduction of such basis only for purposes of determining losses on the ultimate sale of the stock, at least in some circumstances beyond those covered by section 1059.

Analysis

In general

Considerable disagreement exists about the role of the corporate income tax in the U.S. tax system. Many favor the treatment of corporations as entities separate from their shareholders along with the imposition of separate unintegrated taxes on income earned by corporations and on dividends distributed to shareholders. Others, however, contend that the separate taxation of corporations and their shareholders has undesirable economic effects that should be alleviated by providing some relief from the two-tier tax.

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[23] The Reporter's proposal notes that this could occur since assets (in the form of the payment made by the acquiring corporation to the other corporation's shareholders) are removed from corporate solution (of the acquiring corporation) and placed in the hands of the selling shareholders, while the acquiring corporation (unlike the selling shareholders) would be entitled to a dividends received deduction for distributions from the acquired company.

[24] A similar but somewhat more complex approach was discussed by the Treasury in 1983 Testimony. *See* Testimony of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, in "Reform of Corporate Taxation," Hearings before the Committee on Finance, United States Senate, 98th Cong., 1st Sess. (October 24, 1983), at pp. 38-40.

Revenue considerations, perception of the corporate entity, and speculation about the economic effects of a separate corporate level tax, including "who pays the tax" and what economic decisions may be influenced by the existence of the tax, all play a role in the debate on this issue.

Arguments in favor of two-tier tax

Advocates of the two-tier tax generally argue that the corporate tax not only is a source of revenue that might not easily be replaced if the corporate tax were eliminated either directly or indirectly, but also is a tax imposed on an appropriate income base. Imposing a separate corporate income tax is supported by those who view corporations as vehicles for accumulating capital that are entities distinct from the individuals who contributed the capital and who enjoy limited liability with respect to the corporation's obligations and activities.

In many cases, corporations are viewed as not being effectively controlled by shareholders but rather by the corporate officers and directors. It is argued that it is appropriate to treat the earnings on accumulations of capital in such circumstances as a proper base of taxation.[25] In contrast, certain corporations that may be considered as directly controlled by shareholders are permitted to elect treatment under subchapter S, which permits the S corporation to avoid being taxed as a separate entity.[26]

Another argument for the imposition of a separate corporate tax is that it is a necessary "backstop" to the individual income tax in the case of retained earnings. Without either a deemed distribution system analogous to the S corporation model or a substantial corporate tax, income could be accumulated without bearing adequate income tax compared to the amount of tax that would be paid if the income were earned directly by individuals.

For example, if there were either no corporate tax or a corporate tax imposed at a much lower rate than the individual tax, individuals would be able to invest assets in corporations where these assets would earn and accumulate income that was not taxed currently (or only taxed at low rates currently). Such income earned by corporations, to the extent reflected in increased value would be taxed on a deferred basis to the individuals, perhaps at capital gains rates or perhaps not at all in the case of an individual who holds appreciated shares of stock at death (sec. 1014). Thus, some contend that absent full integration, the imposition of a substantial corporate tax on undistributed corporate earnings is at a minimum justified in order to prevent deferral or complete avoidance of taxation of the income earned through corporations.[27]

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[25] *See* Richard Goode, *The Corporation Income Tax* (Wiley, 1951), pp. 24-43; Joseph A. Pechman, *Federal Tax Policy* (Brookings Inst., 4th ed, 1983), p. 130.

[26] Extension of the S corporation model of taxation to other corporations could be viewed as imposing current tax on shareholders with respect to income the distribution of which they do not effectively control. The burden of such an approach could be alleviated if the tax is collected for the shareholders out of corporate funds, as a withholding tax, but differences in the effective rates of shareholders could involve complexity.

Any need for a current corporate tax approximating individual rates on accumulated earnings in order to "backstop" the individual tax and compensate for deferral of individual tax is not, however, necessarily undermined by the granting of relief from the corporate tax on distributed income since the distributed income generally would be taxable immediately to the recipient shareholders, thereby ending any deferral. Some opponents of relief from the two-tier tax may nevertheless contend that the separate tax should be retained without relief even on distribution of earnings, to compensate adequately for deferral that may occur to the extent that an individual's effective rate may exceed a corporation's effective rate. Some also contend that given the distribution of ownership of corporate equity, the two-tier tax adds to the progressivity of the income tax system, and that relief from the two-tier tax would disproportionately benefit wealthy taxpayers.

In addition, some have argued that a two-tier tax system is an appropriate method of preventing tax evasion and shelter activity and otherwise promoting compliance. For example, it has been suggested that tax evasion and tax shelter activity with respect to any particular tax may be greater with higher marginal rates. This observation has led to the suggestion that a two-tier tax with lower rates at each tier rather than a higher-rate single-tier tax is preferable from the standpoint of compliance and avoiding incentives to shelter income.[28]

It has also been argued that countries that have adopted some form of relief from the two-tier tax have done so for reasons unrelated to any theoretical preference for a "conduit" view of the corporation and individual income taxes, e.g., France to stimulate its capital markets and Canada to promote domestic ownership of industry.[29]

Arguments for relief from the two-tier tax

Advocates of relief contend that the relationship of the separate corporate and individual income taxes tends to create certain distortions in economic decisions that should be alleviated by providing some form of relief from the two-tier tax.[30] Such advocates generally contend that the tax system should seek to provide (a) neutrality between corporate and noncorporate investment, (b) neutrality between debt and equity financing at the corporate level, and (c) neutrality between retention and distribution of corporate earnings.

One concern that has been expressed is that the two-tier tax may discourage some from deciding to carry on business in corporate form in situations where nontax considerations indicate that corporate operations would be preferable. The extent to which this may occur depends in large part upon where the corporate tax ultimately falls. As discussed below, there are differing views of the extent to which the burden of the corporate tax is in fact borne by shareholders rather than "passed on" to consumers or employees of corporations. A related concern is that to the extent alternative forms of operation are available that offer some of the advantages of a corporation without the burden of corporate tax (such as a limited partnership), taxpayers effectively can elect whether or not to subject themselves to the corporate tax in any event.[31]

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[27] *See* Pechman, n. 25, *supra.*

[28] *See* Marks, "Tax Income Again and Again," *Wall Street Journal*, June 24, 1985, p. 18.

[29] *See* Surrey, "Reflections on 'Integration' of Corporation and Individual Income Taxes," 28 *National Tax Journal* 335, 335 n.2 (Sept. 1975).

[30] For discussion with analysis of the various possible effects of the two-tier tax, *see, e.g.*, Warren, "The Relation and Integration of Individual and Corporate Income Taxes," 94 *Harv. L. Rev.* 719, 721-738 (1981).

Another concern is that the two-tier tax in its present form may encourage financing corporate investment with debt rather than new equity, because deductible interest payments on corporate debt reduce corporate taxes while nondeductible dividends do not.

For example, if an individual in the 50 percent marginal tax bracket invests $1,000 in a corporation as equity, and the corporation, subject to a 46 percent tax rate, earns a 10 percent ($100) pretax return, there will be only $54 available after corporate tax for distribution and the individual will have only $27 left after individual taxes on this distribution. The total tax on the $100 of earnings is $73 (73 percent). However, if the individual lends $1,000 to the corporation at 10 percent interest, the corporation can deduct the full $100 interest payment so that no corporate tax is paid, while the $100 distribution is subject to a $50 (50 percent) tax in the hands of the individual (the same tax that would have been paid if the $100 were earned outside of corporate solution). Therefore, corporate earnings distributed as dividends are subject to an additional 23 percent tax not borne by earnings distributed as interest.

Accordingly, there may be a incentive for an individual to structure an investment using a large amount of debt rather than equity. Similarly, from the point of view of the corporation and its existing shareholders, new equity from individuals is more costly than debt because greater pre-tax earnings are needed to provide the same market return to the new investor.

On the other hand, the corporate dividends received deduction (which is 85 percent for portfolio investment and can be 100 percent for direct investment) provides an incentive for a corporation to invest in stock rather than debt of another corporation. Furthermore, when an issuing corporation has tax losses so that the interest deduction provides no additional tax benefit, it may be able to issue to corporations preferred stock that mimics debt—for example, providing a floating dividend rate pegged to Treasury bill interest rates—effectively passing through some of the benefit of its losses to corporate shareholders.[32] It is not clear to what extent taxable corporations may respond to tax incentives to issue debt, while corporations that are unable to benefit from an interest deduction because of other tax losses may prefer to issue stock to corporate investors.

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[31] *See* the discussion of entity classification in Part V., below. For example, a profitable corporation that desires to distribute most of its earnings currently may seek to operate in limited partnership form to eliminate the corporate tax on such earnings.

[32] *See* discussion under "Treatment of intercorporate distributions—the dividends received deduction", *infra*.

To the extent that a two-tier tax results in a bias in favor of debt financing, the risk of bankruptcy is increased for corporations, particularly those in cyclical industries. Moreover, the importance of the distinction between debt and equity, both for individual investors and corporate issuers that would prefer investments to be characterized as debt, and for corporate investors and issuers that would prefer investments to be characterized as equity, also generates difficult legal problems in distinguishing between the two.[33]

A further issue is whether the two-tier tax distorts decisions to retain or to distribute corporate earnings. Where shareholders are better able than their corporation to put capital to its most productive use, then a tax-based disincentive to distribute earnings creates an economic inefficiency. Conversely, where a corporation is better able to invest capital than its shareholders, any incentive to distribute earnings also creates an inefficiency. Where the corporation and its shareholders are both able to make the best possible investments, no inefficiency necessarily would result from incentives to retain or distribute earnings. Advocates of relief from the two-tier tax contend that the present system is not neutral with respect to the distribution or retention of earnings, and that increased neutrality is desirable.

The two-tier tax on dividend distributions can make it more desirable for a corporation to use retained earnings, rather than new equity from individuals for its investments. Shareholders can find such earnings retention attractive (subject to the accumulated earnings tax and personal holding company rules) where the shareholder expects to realize the value of such reinvested earnings at preferential capital gains rates on an ultimate redemption or sale of the stock or liquidation of the corporation[34] or intends to hold stock until death, so that appreciation can be passed to his heirs free of individual income tax (sec. 1014).

There is also an incentive under present law to retain earnings if the corporation's current effective tax rate on undistributed earnings is lower than the shareholder's current effective rate on distributed earnings.[35]

On the other hand, where the effective tax rate of the shareholder is significantly lower than the corporate effective tax rate—for example, if the shareholder is a tax-exempt entity or is a corporation entitled to a dividends received deduction—there may be an incentive to distribute earnings.

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[33] Illustrative of the difficulties inherent in distinguishing debt from equity is the fact that in 1969, Congress authorized the Treasury Department to issue such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or debt (sec. 385). In the approximately 16 years since that time, the Treasury has issued and withdrawn several sets of proposed regulations, none of which has ever become effective.

[34] In liquidation, unrealized appreciation in corporate assets may remain untaxed at the corporate level while the shareholder obtains a stepped-up basis at the price of a capital gains tax only. *See* discussion in Part III., below. Advocates of relief from the two-tier tax also point out that the advantage of capital gains treatment for individual shareholders, and of dividend treatment for corporate shareholders, generates difficult legal issues in an attempt to determine whether a particular redemption or other distribution out of corporate solution should be treated as an ordinary income "dividend" or a capital gain "sale" transaction.

[35] Under present law, the top marginal ordinary income tax rate is 50 percent for individuals and 46 percent for corporations. The Administration proposes a top marginal ordinary income tax rate of 35 percent for individuals and 33 percent for corporations. The actual effective rates for a particular corporation or individual of course may vary further, depending, for example, on the availability of tax preferences or other deductions.

Issues regarding incidence of two-tier tax

There is considerable uncertainty about the economic effects of the two-tier tax or the extent of the possible distortions it may cause. While taxes are generally considered to provide a disincentive to savings and investment, there is little agreement concerning the effect of the two-tier tax on economic activity. One source of the uncertainty is the widely varying circumstances of corporations and their shareholders—differing effective tax rates, degree of ownership, behavioral assumptions, etc. Another source is lack of agreement about who bears the burden of the corporate tax either in the short run or the long run.

Many, especially those who favor relief from the two-tier tax, believe that the imposition of the two-tier tax reduces the rate of return for individuals on assets placed in corporate solution. If so, the tax is effectively borne by shareholders whose income then is considered to be overtaxed, with resulting disincentives for savings and investment in activities appropriately conducted in corporate form.

Others, however, believe that the imposition of the two-tier tax results in higher prices for products produced by the corporate sector of the economy, lower wages for workers in the corporate sector, or both, in order that an adequate return remains for the capital invested therein. Thus, to the extent that higher prices or lower wages result from the corporate tax, the burden of the tax is borne by either consumers or workers. To any such extent, the two-tier tax would not necessarily constitute a disincentive for investment in corporate form, although issues would remain relating to the neutrality of the tax system with respect to decisions about debt or equity financing and income retention or distribution.[36]

Some have suggested that relief from the two-tier tax should be granted only as an incentive for particular goals. For example, some proponents of broader employee ownership of corporations have suggested that relief for distributed earnings could be granted only when a corporation has a specified percentage of employee stock ownership, or has an increasing percentage of such ownership. Similarly, it has been suggested that the present law deductibility of interest be limited to situations where the debt is incurred to advance the desired goal.[37]

Method of granting relief

The 10-percent dividends paid deduction contained in the Administration proposal would be a modest step toward elimination of the two-tier tax. Assuming that the rate reductions in the Administration proposal are enacted, the effect of the dividends paid deduction would be to reduce the burden of the two-tier tax from 23 to 20 percentage points.[38]

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[36] Further, to the extent that the corporate tax is "passed on," it could not be said to contribute to the progressivity of the tax system.

[37] Employee stock ownership plans are discussed in a separate pamphlet prepared by the Staff of the Joint Committee on Taxation. *See* n. 2, *supra*.

[38] Under present law, where corporate earnings are taxed at a 46 percent rate and the after-tax earnings are distributed to an individual shareholder who is taxed at a 50 percent rate, the total taxation is 73 percent (.46 + .50(1-.46)) or 23 percentage points greater than a single share-

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In view of revenue needs and the existing uncertainty regarding whether a two-tier tax is inappropriate, some have questioned whether the modest reduction in the possible distortions that the Administration proposal affords in any particular case is worth the estimated five-year (fiscal years 1986-1990) aggregate revenue cost of $21.3 billion.[38a]

Others contend that some measure of relief from the two-tier tax is appropriate. In addition, some contend that the Administration's proposed mechanism for relief may establish an approach that could be expanded if further relief were desired in the future.

Assuming relief from the two-tier tax is considered desirable, a number of different mechanisms—of which the Administration's dividends paid deduction is one—could be considered.

Full integration

Full integration through a deemed distribution and reinvestment system is generally considered to be the most theoretically desirable method of providing the relief, since all income earned at the corporate level would be taxed directly and currently to the shareholders, leaving none of the possible distortions described above.

However, such a system is also considered to be difficult to implement. One traditional objection to this form of relief, concern that imposition of tax at individual rates on allocated corporate income may result in liquidity problems for shareholders whose marginal rates exceed the rate of tax collected at the corporate level, has been substantially diminished by the closer approximation of the top nominal corporate and individual tax rates, though the actual effective tax rate of a particular shareholder and a particular corporation might differ within the range up to the top nominal rates.

Nevertheless, considerable administrative difficulties are inherent in a system of full integration. For example, the need to allocate a corporation's tax attributes among all its shareholders (particularly in the case of a widely held public corporation the shares of which change hands frequently, and adjustments to whose tax attributes is commonplace), as well as the resulting need for individuals to account for potentially complex items such as foreign tax credits, intangible drilling costs and the like, pose what many consider to be insurmountable obstacles to the general implementation of this system.

Lowering corporate taxes

Lowering corporate taxes would reduce the extent of double taxation of corporate earnings. This method of affording relief from the two-tier tax could reduce concerns about incentives for debt financing and under investment in the corporate sector. However, such concerns would not be eliminated so long as there is a corpo-

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holder level tax of 50 percent. Under the Administration proposal, where corporate earnings are taxed at a 33 percent rate but the corporation receives a 10 percent dividends paid deduction, and the after-tax earnings are distributed to an individual shareholder who is taxed at a 35 percent rate, the total taxation is 55 percent ((.33-.033) + .35(1-(.33-.033)) or 20 percentage points greater than a single shareholder level tax of 35 percent.

[38a] Staff of the Joint Committee on Taxation, *Estimated Revenue Effects of the President's Tax Reform Proposal* (JCS–26–85), July 26, 1985.

rate level tax. Moreover, the lower the corporate effective tax rate relative to the individual effective tax rate, the greater the incentive will be for a corporation to retain rather than distribute earnings.

Dividends paid deduction vs. shareholder credit

The dividends paid deduction (proposed by the Administration) and the shareholder credit are generally considered the two most feasible methods of implementing some relief from the two-tier tax and are generally considered economic equivalents. They operate to provide relief only with respect to distributed income. The main economic distinction between the two methods (where a credit is refundable) is that the dividends paid deduction initially puts cash generated by the tax relief in the hands of the corporation, while an imputation system puts the cash in the hands of the shareholders.

The Administration proposal states that the dividends paid deduction is chosen primarily because the Administration considers it somewhat easier than an imputation system to implement. A dividends paid deduction requires no additional accounting by individual recipients of dividends, though it would impose some additional accounting and reporting requirements on a corporation paying dividends. A corporate recipient of dividends would also have accounting requirements that might prove difficult to administer, since accurate accounting for a recipient corporation's QDA may require adjustment to reflect subsequent adjustments in a payor corporation's income tax liability.

An imputation system would impose accounting and reporting requirements similar to those required for the dividends paid deduction on corporations paying and receiving dividends. However, it would also require individual shareholders to account for dividends differently, not simply by including them in income but by using the gross-up and credit calculation.

Nevertheless, an imputation system may offer some advantages over the dividends paid deduction if it is considered desirable to limit the relief in the case of certain shareholders—for example, foreign or tax-exempt shareholders. (*See* discussion under "International Aspects—Foreign shareholders" and under "tax-exempt shareholders", below.) Accordingly, despite the relatively small additional administrative burden placed on individuals, consideration may be given to use of an imputation system rather than a dividends paid deduction if relief from the two-tier tax is to be implemented.

Dividend exclusion for individuals

The Administration proposal would eliminate the present-law dividend exclusion for individuals. As discussed above, the dividend exclusion for individuals tends to benefit high-bracket taxpayers more than low-bracket taxpayers. A dividend credit system, as described above, could provide more equal benefits.

Moreover, according to the Treasury Department, over three quarters of individuals who report dividend income receive the benefit of the entire amount of the exclusion available under present law. For these individuals the exclusion does not lower the marginal income tax rate on dividend income, and thus it appears that the exclusion generally does not encourage additional investment in corporate equity in any significant way. Furthermore, the present dividend exclusion eliminates the tax-based incentives relating to debt or equity financing or the distribution or retention of earnings only to a minimal extent.

Treatment of intercorporate distributions—the dividends received deduction

Distributions out of untaxed earnings

Under the Administration proposal, the dividends paid deduction and the corporate dividends received deduction generally operate to relieve corporate level tax only when earnings are distributed and to ensure that intercorporate distributions do not result in additional corporate level tax.

Under the Administration proposal (as under present law), a corporate shareholder is entitled to a dividends received deduction even when the corporate earnings from which the dividends were paid bore no corporate tax. The proposal grants a 100 percent dividends received deduction in any such case, while present law would grant a 100 percent deduction in the case of certain direct investments and an 85 percent deduction in the case of portfolio investments.

To the extent that permitting a dividends received deduction for corporate shareholders is justified as a means of ensuring that earnings bear only one corporate tax, it may not be appropriate to permit a dividends received deduction where the effect of doing so is to prevent any corporate tax at all.

The ability to pass through losses through intercorporate stock investment can place additional pressure on distinctions between equity and debt. Under present law, preferred stock is often structured so that it has characteristics that make it very similar to debt. For example, the dividend rate on the stock may be related to prevailing interest rates but provide an after-tax yield that is more favorable to a corporate shareholder than fully taxable interest and less costly to the corporate issuer. Either public trading or a call feature (where there is an intention to call) might provide the holder of the preferred stock with access to the return of the advanced funds. A corporation with substantial net operating losses (and thus no current tax liability) may issue preferred stock to another corporation instead of issuing debt. Since the interest deductions on additional debt would not be of any immediate benefit to the issuing corporation, a benefit is effectively transferred to the purchasing corporation which receives dividend income that is 85 percent tax-free instead of fully taxable interest income. Thus, the issuance of preferred stock to a corporation may be considered a technique for transferring tax benefits.

Consideration could be given to limiting the availability of the dividends received deduction to amounts paid out of earnings that have been taxed. An account like the QDA might be used for the purpose of determining whether dividends are paid out of earnings that have been taxed, regardless of whether a dividends paid deduction is implemented.

On the other hand, some may contend that to the extent a corporation has funds available for distribution that have not been taxed and this is a result of tax incentives at the corporate level, the benefit of those incentives should be preserved and passed through as long as the earnings remain in corporate solution. (*See* discussion under "Treatment of tax preference items," below.)

Portfolio investment

Under the Administration proposal, the dividends paid and dividend received deductions operate to relieve corporate level tax on intercorporate distributions without regard to whether the distributee corporation is a mere portfolio investor or is a direct investor that could be viewed as effectively operating through the payee corporation. The Administration proposal is similar to present law in this respect, although present law does impose a maximum 6.9 percent ordinary income tax on intercorporate dividends on portfolio stock, while dividends to a direct corporate investor are not taxed.

Some contend that allowing corporate shareholders a dividends received deduction with respect to portfolio investment is contrary to the general treatment of corporations and shareholders as separate taxable entities. Furthermore, as noted above, given the ability to structure preferred stock so that it closely mimics debt, it is contended that the dividends-received deduction for portfolio investment may frequently permit loss passthroughs between otherwise unrelated corporations.[39]

Dividends received deduction and shareholder basis

Under present law, as under the Administration proposal, the basis of a corporate shareholder's stock in another corporation is not generally reduced when dividends that are excludable from the recipient's income are paid.[40]

Present law does require reduction of basis where certain "extraordinary dividends" are paid on stock held less than a year (sec. 1059). This rule, added by the Deficit Reduction Act of 1984, is intended to prevent certain "tax arbitrage" transactions. In these transactions, a corporation would buy stock of another corporation prior to a large dividend payment (at a purchase price reflecting the value of the dividend). The corporate stockholder would receive the dividend subject to a maximum 6.9 percent tax due to the dividends received deduction, retain its original stock basis, and then sell the stock, after the dividend, at a loss (reflecting a market decline of approximately the amount of the dividend) worth up to 46 percent in offsetting unrelated short-term capital gain income. The transaction could thus produce a net 39 percent tax benefit.

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[39] In the past, Congress has limited the benefits of the dividends received deduction in certain cases. For example, in the Deficit Reduction Act of 1984, Congress added section 301(f), which provides that certain provisions of section 312 (relating to the computation of earnings and profits) would not apply with respect to distributions to certain "20-percent shareholders," where the effect of applying such provisions would tend to treat a greater amount of distributions as eligible for the dividends received deduction. That Act also added section 246A, which limits the availability of the deduction in certain cases where a corporate shareholder holds portfolio stock that was debt financed.

[40] Under Treasury regulations, in the case of affiliated corporations filing a consolidated tax return, the basis of a parent corporation's stock is generally reduced by dividends out of pre-affiliation earnings (deemed reflected in the parent's basis) or out of post-consolidation earnings and profits that have increased basis (Treas. Reg. sec. 1.1502-32).

There may be instances under present law where corporate taxpayers might take advantage of the dividends received deduction and possibly convert a pre-tax economic loss into an after tax profit. For example, a corporation may acquire stock of another corporation (in a takeover attempt or otherwise) and surrender a portion of the stock (possibly for a premium price) in a redemption transaction intended to qualify as a dividend. If the redemption does qualify as a dividend and the corporation avoids the provisions of section 1059 that would reduce the basis of the shares (perhaps by holding the stock for more than one year), then any diminution in value of the shares resulting from the redemption transaction would generate a capital loss for the shareholder. Thus, the shareholder may incur a tax on the dividend at a 6.9 percent rate (after application of the dividends received deduction) but generate a long-term capital loss (or reduce capital gain) in an amount reflecting the dividend distribution, resulting in a 28 percent tax benefit. If the dividend and the loss were equal in amount, this might produce a net 22 percent tax benefit.

This type of situation has led to suggestions that a recipient corporation be required to reduce its basis in the stock of the distributing corporation by the amount of dividends excluded from the recipient's income because of the dividends received deduction, or at least be required to reduce such basis for purposes of determining losses on ultimate sale of the stock in circumstances beyond those covered by section 1059. Nevertheless, some may contend that where more than a year has passed since the stock was acquired, there may have been substantial earnings at the corporate level that were not originally reflected in the stock basis and it may be inappropriate to link dividends paid with any losses on sale of the stock.

Treatment of tax preference items

The treatment of tax preference items, such as certain exclusions from income, credits against income tax, or tax deductions that exceed economic expense, must be examined in the context of proposals for relief from the two-tier tax on income earned by corporations. The purpose of this examination is to consider whether and to what extent preference items available to a corporation should be passed through to shareholders in conjunction with the implementation of any proposal for relief from the two-tier tax on corporate income.[41]

In general, a system of relief that passes through tax preferences not only allows the preference to reduce the corporate tax of the corporation engaging in the activity for which the incentive is granted, but also directly or indirectly allows preference items attributable to that activity to reduce the shareholder income tax liability on distributions from the corporation.

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[41] *See* William McLure, *Must Corporate Income Be Taxed Twice*? (Brookings Inst., 1979), pp. 92-143 for a comprehensive discussion of the treatment of tax preferences in the context of granting relief from the two-tier tax.

If the purpose for granting relief from the two-tier tax is to eliminate corporate level tax entirely and to treat corporate income as earned directly by shareholders, it could be argued that all preference items of a corporation should be attributed directly to its shareholders, regardless of whether they are individuals or other corporations.

On the other hand, relief from the two-tier tax may be considered simply an effort to eliminate the burden of any existing corporate level tax, at least so long as funds remain in corporate solution. Although most preference items are available both to corporations and individuals, it may be argued the effect of various preferences in the Code is largely to reduce corporate taxes. For example, even though the investment credit and ACRS are available to both corporations and individuals, these provisions benefit corporations in overwhelming proportions.[42] Under this view, it would be inappropriate to permit provisions that reduce corporate income taxes to reduce the income taxes of a corporation's individual shareholders as well. Nevertheless, it may be considered appropriate to assure that the benefit of a preference item is continued so long as the related income remains in corporate solution (even though distributed to a corporate shareholder that has made a portfolio investment and is otherwise unrelated to the distributing corporation).

Any mechanism for passing through preferences to shareholders would vary depending upon the method chosen to provide relief from the two-tier tax (i.e., shareholder credit system, dividends paid deduction, etc.) and whether the preference item takes the form of an exclusion, a credit or an accelerated deduction.[43] Similarly, any mechanism for denying the passthrough of preferences to shareholders would depend on the type of system employed.[44]

If relief from the two-tier tax is granted with respect to distributed income only (as is the case with either a dividends paid deduction or a shareholder credit system), a determination must be made whether the distribution has been from taxed or untaxed earnings. Three different approaches are possible.

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[42] For example, the Joint Committee on Taxation estimates that the Administration proposal to repeal the investment credit will result in the collection of $117.2 billion in additional tax revenue from corporations and $22.2 billion from individuals during the period 1986-1990. (See reference in n. 38a, *supra*.)

[43] For example, if a shareholder credit system were to pass through tax credits, the proper gross-up and credit amount would equal actual corporate income taxes paid plus allowable credits. (Credits that could not be used to reduce corporate income taxes could either be passed through to the shareholders or remain with the corporation.) To pass through excludable income or accelerated deductions, distributions in excess of the corporation's taxable income would either have to be excludible by the shareholders, or the shareholders would have to be given a larger credit. If a dividends paid deduction were chosen instead, excludible income and accelerated deductions could be passed through by excluding from the shareholder's income distributions in excess of the corporation's taxable income. Credits could be passed through by excluding from shareholders' income distributions in excess of the corporation's taxable income reduced by the amount of income, the tax on which is offset by the available credits. With either a shareholder credit system or a dividends paid deduction, where the passed-through preference is an accelerated deduction, adequate provision must be made to assure that the tax deferral that such deductions are intended to provide does not result in complete exclusion.

[44] In a shareholder credit system, the passthrough of both credits and accelerated deductions or untaxed income is denied by limiting the gross-up and credit to actual taxes paid. Alternatively, if a uniform gross-up rate were desired, a compensatory tax could be imposed on a corporation to the extent that the credit available to its shareholders with respect to dividends paid exceeds the amount of corporate tax paid by the corporation. If a dividends paid deduction were used, the passthrough could be denied by limiting the deduction to the excess of taxable income over the amount that if granted to the corporation as a deduction would yield the same tax benefit as any credits used by the corporation to reduce its tax liability.

The first approach treats dividends as paid pro rata from taxed and untaxed corporate income. Thus, if a dividends paid deduction were used, for example, a corporation that has $100 of economic income but only $50 of taxable income would treat 1/2 (i.e., $50 divided by $100) of its dividends paid as eligible for the dividends paid deduction.

The second approach treats dividends as paid first out of income that has not been taxed and denies any dividends paid deduction unless distributions exceed a corporation's taxable income.

The third approach—which is the approach adopted by the Administration proposal—treats dividends as paid first out of income that has borne corporate tax. This approach might be viewed as permitting some amount of corporate tax incentives to be applied to reduce the double tax on distributions of earnings that did bear corporate tax. To this extent, it might be seen as permitting an indirect additional benefit to all shareholders from corporate level preferences. However, this approach is significantly simpler to implement than either of the others, in terms of the accounting that it would require.

Under the Administration proposal, all corporate income that was subject to tax would be added to the QDA in full even if the tax were imposed at less than the top corporate rate. This would include, for example, long-term capital gain that was taxed at preferential capital gains rates.[45]

Where a corporation with long-term capital gain also has ordinary income, it is possible that a 10 percent dividends paid deduction would offset more than 10 percent of the corporation's tax liability on the related income. Consideration may be given to reducing the amount added to the QDA with respect to net capital gain, in order to avoid granting greater benefits with respect to such corporate income.

International aspects

Foreign shareholders

A significant international tax issue raised by proposals for relief from the two-tier tax on corporate income is whether such relief should be granted with respect to shares in a U.S. corporation owned by foreign shareholders and, if so, to what extent. If either denial or limitation of the relief is desired, a related issue is the manner in which the relief may be denied or limited within the framework of present U.S. income tax treaties.

Denial of relief where there are foreign shareholders is arguably inconsistent with the goals of avoiding some of the distortions of the two-tier tax; these distortions arise irrespective of the nationality of the shareholder or the country that receives the shareholder level tax. On the other hand, the relief arguably is not intended to lessen the U.S. taxation of income earned by foreigners through U.S. corporations, particularly where under an existing income tax treaty, such foreign shareholders pay little tax on dividends received from U.S. corporations. In addition, most other countries that have adopted some form of relief from a two-tier tax generally do not extend the relief to foreign shareholders unilaterally; some countries, however, provide relief for foreign shareholders through bilateral treaties.

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[45] It would also include income taxed at marginal rates lower than the rates against which the dividends-paid deduction is taken. For example, corporate income tax may be paid in one year at a 15-percent rate, and dividends paid out of this income may give rise to a 10-percent dividends paid deduction that offsets income in the 33-percent bracket. The contrary result could also occur. If this were perceived as a problem, the benefit of a deduction arising from the distribution of income taxed at a different rate could be adjusted to reflect the amount of tax paid on such income, though this could involve significant tracing complexity.

If relief from the two-tier tax is implemented through a dividends paid deduction, such relief can be denied where there are foreign shareholders, either by denying the deduction to the corporation for dividends paid to foreign shareholders or by imposing a compensatory withholding tax (in addition to any other withholding tax) equal to the tax benefit received by the corporation on the dividends paid to foreign shareholders.

Although disallowance of the dividends paid deduction would accomplish the goal of collecting tax on income earned in the United States, it may be considered unfair and undesirable for the value of the U.S. shareholders' shares to be affected by the fact that other shareholders are foreign. Accordingly, apart from treaty considerations discussed below, a compensatory withholding method may be preferable since the benefit of the relief is in effect "paid back" directly only by foreign shareholders rather than proportionately by all shareholders.

If an imputation system, rather than a dividends paid deduction, were used to implement the relief, the relief could be denied entirely to foreign shareholders by not permitting the gross-up and credit, or could be denied in part in some cases by not permitting a refund of any unused credit. Where the degree of relief contemplated is relatively small, however, as is true of the Administration proposal, nonrefundability may not be meaningful since in many cases the appropriate credit may be less than the pre-credit U.S. taxes payable even where such taxes are reduced pursuant to a treaty.

If relief from the two-tier tax is to be denied to foreign shareholders who are entitled to a maximum rate of tax on dividends pursuant to a treaty, the method chosen to deny relief may have a bearing on whether the denial can be viewed as a violation of the treaty in question. In particular, the imposition of a compensatory withholding tax in conjunction with a dividends paid deduction could be considered a technical violation of treaties that provide a maximum withholding rate on dividends. This is so despite the fact that the compensatory withholding tax is a substitute for the collection of additional corporate tax, which would not violate these treaties. Moreover, if a shareholder credit system were adopted and the credit were denied to foreign shareholders, the same substantive result would be reached without any arguable treaty violation.[46]

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[46] Discussion of considerations relating to the potential treaty violations arising from this proposal is contained in a separate Joint Committee pamphlet, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers* (JCS-25-85), July 18, 1985, pp. 141-147.

As discussed above, the Administration proposal would impose a compensatory withholding tax on dividends paid to foreign shareholders who are not entitled to treaty benefits but, at least initially, would not impose the additional withholding on shareholders who are entitled to treaty benefits. The proposal retains authority for the Treasury to impose the additional withholding in order to retain bargaining power in negotiating reciprocal relief for U.S. shareholders of foreign corporations where the foreign corporation's national shareholders are afforded relief from a two-tier tax. If Treasury did not impose such withholding, this approach could have the effect of permanently lowering, without compensation, the U.S. tax on income earned by corporations to the extent the corporation has shareholders in any of the many countries that offer no relief from two-tier taxation.

Foreign corporations

Under the Administration proposal, a foreign corporation is not entitled to the dividends paid deduction even with respect to dividends paid from earnings that were subject to U.S. tax. Certain treaties arguably may provide, however, that foreign persons (including corporations) are entitled to the same U.S. income tax treatment as a similarly situated U.S. person. Accordingly, consideration may be given to extending the deduction to foreign corporations entitled to such treatment under a treaty, where dividends are paid to U.S. shareholders from earnings subject to U.S. tax. Alternatively, such a foreign corporation could be given an election to be treated as a United States corporation for all income tax purposes.[47]

Source rules

The Administration proposal indicates that the dividends paid deduction should be allocated between U.S. and foreign source income in proportion to the income out of which the dividends were paid. No method is specified for determining the income from which the dividends were paid. Where dividends paid could be attributed to more than one year, the choice can have significant practical impact. For example, if, in a year that a corporation has excess foreign tax credits, it pays dividends with respect to which it is entitled to a dividends paid deduction, the availability of the corporation's foreign tax credits may be further restricted if the dividends paid are deemed to be paid out of earnings from a year in which the corporation had a relatively high percentage of foreign source income. The availability of the foreign tax credits may be enhanced, however, if the dividends are deemed to be paid out of earnings in a year in which the corporation had a relatively high percentage of domestic source income.

Therefore, consideration may be given to the provision of appropriate allocation rules in connection with the adoption of a dividends paid deduction. Possible rules include proportionate allocation to the earliest years, to the most current years, or to all accumulated earnings. Consideration should be given, however, to possible manipulation of the timing of dividend payments that these rules might foster.[48] The deduction might also be allocated first to U.S. or first to foreign income. Allocating all dividends first to foreign source income might be considered harsh, while allocation first to U.S. income may be inappropriately lenient.

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[47] *Cf.* sec. 897(i).

Treatment of foreign tax credit

As discussed above, the Administration proposal generally would not permit a dividends paid deduction at the corporate level to the extent dividends are paid out of earnings that bore no corporate tax. The proposal treats corporate income that did bear foreign tax, but that did not bear U.S. tax due to the foreign tax credit, in the same manner as income that did not bear U.S. tax for other reasons such as accelerated depreciation or other tax preference items. Thus, income that does not bear from U.S. tax due to the foreign tax credit is not added to the QDA.

There is controversy about whether the foreign tax credit should properly be treated in the same manner as a "preference" item. The credit is widely used by countries to reduce international double taxation. It is generally available only where foreign taxes are paid or accrued, thus reducing the amounts a corporation will have available for distribution. On the other hand, foreign countries that have adopted some form of relief from corporate double taxation generally do not treat foreign taxes paid by their domestic corporations as taxes paid, for purposes of a shareholder credit or comparable provision.

Some may contend that the Administration proposal does not provide equal treatment for U.S. and foreign investment by U.S. corporations, because the dividends paid deduction is allowed for distributions of income that has borne only U.S. tax, but not for income that has borne a comparable foreign tax. Others may contend that a U.S. tax benefit has been derived from the foreign tax credit, even though foreign taxes have also been paid. They may also contend that the U.S. should not unilaterally grant relief where other countries do not.

Tax-exempt shareholders

The Administration proposal contains no special rules for situations where a corporation has tax-exempt shareholders such as charitable organizations or tax-qualified pension plans.

Where relief from the two-tier tax is granted, the treatment of shareholders who are tax-exempt raises difficult issues. Denying the relief could be viewed as inappropriately diminishing the relative advantage of tax exemption over ordinary taxable status. On the other hand, granting the relief where a shareholder is a tax-exempt entity could permit business income earned by a taxable corporation and distributed to its tax-exempt shareholders to escape tax entirely, simply because the shareholders are tax-exempt.

As one example, if a taxable corporation owned entirely by a tax-exempt entity distributed all its income, and if there were a 100 percent dividends paid deduction, the corporation would pay no tax. This result would be inconsistent with the rules that tax unrelated business income of tax-exempt entities and generally do not permit tax-exempt entities to engage in regular business activities free of tax on the business income. Although the Administration proposes only a 10 percent (rather than 100 percent) dividends paid deduction, the issue is inherent in the proposal.

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[48] *Compare* problems arising in connection with the deemed-paid foreign tax credit, discussed in a separate Joint Committee pamphlet, n. 46, *supra*, pp. 63-70.

If it were considered desirable to deny the relief in the case of distributions to tax-exempt shareholders, and a dividends paid deduction were chosen as the basic method of relief, the relief could be denied by treating the deductible portion of dividends paid to tax-exempt entities as unrelated business income. This would require reporting of the same type already required by the Administration for dividends paid to corporations.

Such an approach would be similar to the compensatory withholding tax the Administration proposes for certain foreign shareholders; however, the tax would not be collected by the paying corporation as a withholding agent. A withholding tax approach could be used if desired.

Another possibility would be to deny the dividends paid deduction to a corporation that is owned entirely, or to a specified extent, by tax exempt entities. Where a corporation is owned both by taxable persons as well as tax-exempt entities, however, denial of the dividends paid deduction for dividends paid to tax-exempt shareholders would impose an additional tax burden on the taxable shareholders. If an imputation credit system were used, the credit could simply be denied (i.e., be made nonrefundable) in the case of a tax-exempt shareholder.

Transition issues

Certain issues exist relating to the one-time effects of implementing some measure of relief from the two-tier tax. One such issue is whether the relief may give a windfall to present owners of corporate equity, whose shares may become more valuable because of the lower corporate tax burden. The extent of this windfall is somewhat speculative because of uncertainty about the incidence of the corporate tax. To the extent the corporate tax is passed on to consumers or employees, for example, its elimination would not necessarily provide a windfall to shareholders, at least in the long run. Nevertheless, if the possibility of a windfall were perceived to be a problem, one solution would be a phase in of the relief. Another solution would be to extend the relief only to equity issued after the the relief provisions generally become effective, as suggested by the ALI Reporter's study.

Considerations relating to the revenue impact of any major relief also might favor distinguishing new equity from equity existing at the time such relief is granted.

Nevertheless, any approach that requires distinguishing new from old equity may raise substantial administrative difficulties, particularly with respect to situations where a corporation has undertaken various capital transactions—for example, a redemption of old stock and issuance of new stock, possibly to some of the "old" shareholders.

III. DISTRIBUTIONS AND LIQUIDATING SALES OF APPRECIATED ASSETS—THE *GENERAL UTILITIES* RULE

Present Law and Background

Overview

As a general rule, corporate earnings from sales of appreciated property are taxed twice, first to the corporation when the sale occurs, and again to the shareholders when the net proceeds are distributed as dividends. At the corporate level, the income is taxed at ordinary rates if it results from the sale of inventory or other ordinary income assets, or at capital gains rates if it results from the sale of a capital asset held for more than six months. With certain exceptions, shareholders are taxed at ordinary income rates to the extent of their pro rata share of the distributing corporation's current and accumulated earnings and profits (*see* Part II, above).

An important exception to this two-level taxation is the so-called *General Utilities* rule.[49] The *General Utilities* rule permits nonrecognition of gain by corporations on certain distributions of appreciated property[50] to their shareholders and on certain liquidating sales of property. Thus, its effect is to allow appreciation in property accruing during the period it was held by a corporation to escape tax at the corporate level. At the same time, the transferee (the shareholder or third-party purchaser) obtains a stepped-up, fair market value basis under other provisions of the Code. The "price" of a step up in the basis of property subject to the *General Utilities* rule is typically a single, capital gains tax paid by the shareholder on receipt of a liquidating distribution from the corporation.

Although the case involved a dividend distribution of appreciated property by an ongoing business, the term "*General Utilities* rule" is often used (and will be used herein) in a broader sense to refer to the nonrecognition treatment accorded in certain situations to liquidating as well as nonliquidating distributions to shareholders and to liquidating sales. The rule is codified in several elaborate and often complex provisions of the Internal Revenue Code. Section 311 governs the treatment of nonliquidating distributions of property (dividends and redemptions), while section 336 governs the treatment of liquidating distributions in kind. Section 337 provides nonrecognition treatment for certain sales of property pursuant to a plan of complete liquidation.

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[49] *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

[50] Taxable gain may result on disposition of property even if the property's economic value remains constant (or decreases) over the taxpayer's holding period, due to tax depreciation and other downward adjustments to basis. The term "appreciated property" as used herein refers to property whose fair market value exceeds its adjusted (and not necessarily its original) basis in the hands of the transferor corporation.

As described in the historical discussion below, numerous limitations on the *General Utilities* rule, both statutory and judicial, have developed over the years. Some directly limit the statutory provisions embodying the rule, while others, including the collapsible corporation provisions, the recapture provisions, and the tax benefit doctrine, do so indirectly.

Case law and statutory background

Genesis of the General Utilities rule

The precise meaning of *General Utilities* has been a matter of considerable debate since the decision was rendered in 1935. The essential facts were as follows. General Utilities had purchased 50 percent of the stock of Islands Edison Co. in 1927 for $2,000. In 1928, a prospective buyer offered to buy all of General Utilities' shares in Islands Edison, which apparently had a fair market value at that time of more than $1 million. Seeking to avoid the large corporate-level tax that would be imposed if it sold the stock itself, General Utilities offered to distribute the Islands Edison stock to its shareholders with the understanding that they would then sell the stock to the buyer. The company's officers and the buyer negotiated the terms of the sale but did not sign a contract. The shareholders of General Utilities had no binding commitment upon receipt of the Islands Edison shares to sell them to the buyer on these terms.

General Utilities declared a dividend in an amount equal to the value of the Islands Edison stock, payable in shares of that stock. The corporation distributed the Islands Edison shares and, four days later, the shareholders sold the shares to the buyer on the terms previously negotiated by the company's officers.

The Internal Revenue Service took the position that the distribution of the Islands Edison shares was a taxable transaction to General Utilities. Before the Board of Tax Appeals,[51] the Commissioner's rationale was that the company had created an indebtedness to its shareholders in declaring a dividend, and that the discharge of this indebtedness using appreciated property produced taxable income to the company under the holding in *Kirby Lumber Co.* v. *United States*.[52] The Board rejected this argument, holding that where a dividend resolution imposes only the obligation to distribute in kind and it is discharged in that manner, the corporation realizes no gain or loss. It found that General Utilities had declared and paid a dividend in Islands Edison stock.

Before the Fourth Circuit,[53] the Commissioner renewed his discharge of indebtedness argument and raised a new argument. He argued that the sale of the Islands Edison stock was in reality made by General Utilities rather than by its shareholders following distribution of the stock. The court, while agreeing with the court below in rejecting the discharge of indebtedness argument, found that the shareholders were merely the agents or conduits of the true seller, General Utilities. It held that since the transaction was in substance a sale by General Utilities, gain was realized and must be recognized by the corporation.

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[51] 29 B.T.A. 934 (1934)
[52] 284 U.S. 1 (1931).
[53] 74 F.2d 972 (4th Cir. 1935).

Before the Supreme Court, the Commissioner made both of the arguments advanced in the courts below and raised a third argument. He argued that a distribution of appreciated property by a corporation in and of itself constitutes a realization event. All dividends are distributed in satisfaction of the corporation's general obligation to pay out earnings to shareholders, he contended, and the satisfaction of that obligation with appreciated property causes a realization of the gain.

The Supreme Court affirmed the holdings of both of the lower courts that the distribution did not give rise to taxable income under a discharge of indebtedness rationale. It reversed the Court of Appeals' decision on the imputed sale theory on procedural grounds, however, holding that the court should not have considered an argument not presented to the trial court. The Court did not directly address the Commissioner's third argument, that the company realized income simply by distributing appreciated property as a dividend. There is disagreement over whether the Court rejected this argument on substantive grounds or merely on the ground it was not timely made. Despite the ambiguity of the Supreme Court's decision, however, subsequent cases interpreted the decision as rejecting the Commissioner's third argument and as holding that no gain is realized on corporate distributions of appreciated property to its shareholders.

Five years after the decision in *General Utilities*, in a case in which the corporation played a substantial role in the sale of distributed property by its shareholders, the Commissioner successfully advanced the imputed sale argument the Court had rejected earlier on procedural grounds. In *Commissioner* v. *Court Holding Co.*,[54] the Court upheld the Commissioner's determination that in substance the corporation rather than the shareholders had executed the sale and, accordingly, must recognize gain.

In *United States* v. *Cumberland Public Service Co.*,[55] the Supreme Court reached a contrary result where the facts showed the shareholders had in fact negotiated a sale on their own behalf. The Court stated that Congress had imposed no tax on liquidating distributions in kind or on dissolution, and that a corporation could liquidate without subjecting itself to corporate gains tax notwithstanding a primary motive to avoid the corporate tax.[56]

In its 1954 revision of the Internal Revenue Code, Congress reviewed *General Utilities* and its progeny and decided to deal with the corporate-level consequences distributions statutorily. It essentially codified the result in *General Utilities* by enacting section 311(a), providing that no gain or loss is recognized to a corporation on a distribution of property with respect to its stock. Congress also enacted section 336, which in its original form provided for nonrecognition of gain or loss to a corporation on distributions of property in partial or complete liquidation. As discussed below, section 336 no longer applies to distributions in partial liquidation, though in certain limited circumstances a distribution in partial liquidation may still qualify for nonrecognition at the corporate level. Finally, Congress in the 1954 Act provided that a corporation does not recognize gain or loss on a sale of property if it adopts a plan of complete liquidation and distributes all of its assets to its shareholders within 12 months of the date of adoption of the plan (sec. 337). Thus, the distinction drawn in *Court Holding Co.* and *Cumberland Public Service Co.*, between a sale of assets followed by a liquidating distribution of the proceeds and a liquidating distribution in kind followed by a shareholder sale, was in large part eliminated.

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[54] 324 U.S. 331 (1945).

[55] 338 U.S. 451 (1950).

[56] *Id.* at 454-455.

Regulations subsequently issued under section 311 acknowledged that a distribution in redemption of stock constituted a "distribution with respect to ... stock" within the meaning of the statute.[57] The 1954 Code in its original form, therefore, generally exempted all forms of nonliquidating as well as liquidating distributions to shareholders from the corporate-level tax.

Nonliquidating distributions: section 311

Three exceptions to the rule that gain was not recognized on nonliquidating distributions were provided under section 311. The purpose of these exceptions was to eliminate what were perceived to be opportunities for tax avoidance presented by the general rule. First, nonrecognition was not available for distributions of installment obligations to shareholders. Under the predecessor of section 453B, a corporation recognized gain to the extent of the excess of the face value of the obligation over the corporation's adjusted basis in the obligation.[58] Second, upon distribution of LIFO inventory,[59] a corporation recognized gain to the extent the basis of inventory determined under a FIFO method exceeded its LIFO value.[60] Third, a corporation recognized gain on the distribution of encumbered property to the extent the liabilities exceeded the basis of the property in the distributing corporation's hands.[61] These three statutory exceptions to section 311 have remained essentially unchanged since their enactment.

1969 amendments.—On three separate occasions since the enactment of section 311, Congress has reacted to perceived abuse of the provision by further restricting its scope. In 1969, Congress became aware of instances of large corporations making tender offers for their own stock and using appreciated portfolio stock to effectuate the redemption. These transactions were viewed as having the same economic effect as if the distributing corporations had sold the portfolio stock and redeemed their own stock with the proceeds. Congress "[did] not believe that a corporation should be permitted to avoid tax on any appreciated property (investments, inventory, or business property) by disposing of property in this manner."[62]

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[57] Treas. Reg. sec. 1.311-1(a).

[58] Under both the original statute and present law, installment obligations received by a corporation in a sale or exchange qualifying for nonrecognition under section 337 may be distributed to shareholders without recognition at the corporate level. Sec. 453B(d)(2).

[59] Under the last-in, first-out or "LIFO" method of accounting, goods purchased or produced most recently are deemed to be the first goods sold. During periods of rising costs, LIFO inventory accounting tends to increase cost of goods sold and reduce gross income from sales.

[60] Sec. 311(b). "FIFO" (first-in, first-out) accounting assumes that the first goods purchased or produced are the first goods sold.

[61] Sec. 311(c). This rule would prevent, for example, a corporation's borrowing against appreciated corporate assets and immediately transferring the mortgaged assets to its shareholders—thus achieving the same economic position as if it had sold assets.

Congress addressed this problem by amending section 311 to require recognition of gain by a corporation on distributions in redemption of its stock. (For purposes of section 311, a redemption included a distribution in exchange for stock that was treated as a dividend subject to section 301, e.g., because it was "essentially equivalent to a dividend.") Certain types of redemptions were excepted, including distributions in complete termination of a 10 percent shareholder's interest, certain distributions of the stock or obligations of a 50 percent-or-more subsidiary, distributions to pay death taxes, distributions to private foundations, distributions by regulated investment companies upon the demand of a shareholder, distributions pursuant to certain antitrust decrees, and distributions constituting divestitures by bank holding companies.

TEFRA amendments.—In 1982, Congress, again responding to highly publicized tax avoidance transactions involving distributions of appreciated assets, further narrowed the applicability of the *General Utilities* rule. The transactions involved arrangements between a corporation and a prospective purchaser of a subsidiary of the corporation whereby the purchaser made a tender offer for shares of the parent's stock equal in value to the subsidiary's stock. The parent would then, pursuant to a prearranged plan, redeem the stock held by the purchaser using the stock of the subsidiary.

Although it was unclear whether these transactions qualified for nonrecognition treatment under then-existing law,[63] Congress believed it was desirable to clarify that they did not. Moreover, it determined that whether or not the stock ownership was transitory, as in the publicized cases, a distribution of property in a stock redemption was economically equivalent to a direct sale of the distributed property and should generally be treated as such for tax purposes. Congress felt that as a general rule, property should not be allowed to leave corporate solution in a redemption and take a stepped-up basis in the hands of a transferee without a corporate level tax being paid on the appreciation.

Under amendments made in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the general rule in the case of distributions to *corporate* shareholders in redemption of their stock was that the distributing corporation recognized gain. Thus, for example, the exceptions to recognition for distributions in complete redemption of the stock of 10 percent shareholders and for distributions of stock or obligations of a 50 percent subsidiary were repealed in the case of corporate distributees. In a liberalization of prior law, however, nonrecognition treatment was accorded to redemption distributions to corporate shareholders constituting a dividend. In such a case, the distributed property would generally take a carryover rather than a fair market value basis in the hands of the distributee.[64]

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[62] S. Rep. No. 552, 91st Cong., 1st Sess. 279 (1969).

[63] Section 311(a) applies only if a distribution is to a shareholder in its capacity as a shareholder, and not in some other capacity such as vendee. Rev. Rul. 83-38, 1983-1 C.B. 76. *See also* Rev. Rul. 80-221, 1980-2 C.B. 170 (transaction that was in form a redemption of stock with corporate property treated as direct sale of assets to distributee where stock ownership was transitory).

Distributions in redemption of the stock of *noncorporate* shareholders (including S corporations) generally resulted in recognition of gain to the distributing corporation under the TEFRA amendments unless the distribution was to certain substantial, long-term shareholders and consisted of stock or obligations of a subsidiary.[65] As discussed below, an exception was also provided for certain redemptions of stock held by noncorporate shareholders constituting partial liquidations.

The TEFRA amendments did not disturb the exceptions for distributions to pay death taxes, to private foundations, and regulated investment companies.

1984 amendments.—The applicability of the *General Utilities* rule to nonliquidating distributions was eroded still further by amendments in the Deficit Reduction Act of 1984.[66] Prior to the 1984 Act, the gain recognition rule of section 311(d)(1) applied only to distributions of property in redemption of a shareholder's stock. The 1984 Act extended the gain recognition rule to most dividend distributions of appreciated property, including carryover basis distributions to corporate shareholders (whether or not in redemption of stock). In general, dividend distributions to noncorporate shareholders are also subject to the gain recognition rule. However, the 1984 Act preserved nonrecognition at the corporate level for distributions of "qualified dividends," defined as dividends to noncorporate shareholders of property (other than inventory or receivables) used in the active conduct of certain "qualified businesses."[67] The Act also retained nonrecognition treatment for certain redemption distributions with respect to qualified stock held by noncorporate shareholders. Unlike prior law, the 1984 Act required the application of the LIFO recapture and installment obligation rules before the application of the recognition rules of section 311(d)(1).

Liquidating distributions and sales: sections 336 and 337

The rules regarding nonrecognition of gain on distributions in liquidation of a corporation are more liberal than those applicable to nonliquidating distributions. Section 336 as enacted in 1954 Code provided for nonrecognition of gain or loss by a corporation on the distribution of property in complete or partial liquidation of the corporation. An exception was provided (that is, gain was recognized) for a distribution of an installment obligation acquired other than in a liquidating sale that would be tax-free under section 337.[68]

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[64] Sec. 301(d)(2). The distributee's basis would be the fair market value of the property if that were lower than the distributor's basis.

[65] More specifically, the distribution had to be with respect to "qualified stock," more than 50 percent in value of the subsidiary's stock had to be distributed, and certain active business requirements had to be satisfied. "Qualified stock" was defined as stock held by noncorporate shareholders owning 10 percent or more in value of the distributing corporation's outstanding stock for at least five years (or the period the corporation had been in existence, if shorter).

[66] Pub. L. 98-369, sec. 54.

[67] Sec. 311(a)(3). A "qualified business" is any trade or business that has been actively conducted for five years and was not acquired in a transaction in which gain or loss was recognized during such period. Sec. 311(e)(2)(B)(i).

[68] Sec. 453(d), the predecessor of sec. 453B(d). Section 453(d) also provided (and sec. 453B(d) now provides) that no gain or loss is recognized by a corporation on distribution of an install-

Continued

Section 336, unlike section 311, has survived with relatively few modifications since its enactment. TEFRA amended this provision to make it inapplicable to partial liquidations, but granted nonrecognition treatment elsewhere in the Code for certain partially liquidating distributions made with respect to qualified stock. Qualified stock is defined in the same manner as for nonliquidating distributions. Nonrecognition is therefore limited to distributions to long-term, 10 percent shareholders other than corporations.[69] TEFRA also required recognition of the LIFO recapture amount in liquidating distributions.

Section 337 has likewise remained essentially in its original form. It provides that if a corporation adopts a plan of complete liquidation and within 12 months distributes all of its assets in complete liquidation, gain or loss on any sales by the corporation during that period is generally not recognized.[70] Section 337 does not apply, and recognition is required, on sales of inventory (other than inventory sold in bulk), stock in trade, or property held primarily for sale to customers in the ordinary course of business. If the corporation accounts for inventory on a LIFO basis, section 337 requires that the LIFO recapture amount be included in income.

Special rules for distributions by S corporations

The Code allows a closely-held business operating in corporate form to elect to have business gains and losses taxed directly to or deducted directly by its individual shareholders. This election is available under subchapter S of the Code (secs. 1361–1379). The principal advantage of a subchapter S election to the owners of a business is the ability to retain the advantages of operating in corporate form while avoiding double taxation of corporate earnings.

Prior to 1983, shareholders of corporations making a subchapter S election were taxed on actual cash dividend distributions of current earnings and profits of the corporation, and on undistributed taxable income as a deemed dividend. Accordingly, all of the taxable income of a corporation taxable under subchapter S generally passed through to its shareholders as dividends. A shareholder increased his basis in his stock by the amount of his pro rata share of undistributed taxable income.

The Subchapter S Revision Act of 1982 substantially modified these rules. The dividends-earnings and profits system was abandoned in favor of a pass-through approach based more closely on the system under which partnership income is taxed. Under these new rules, gain must be recognized by an S corporation (which gain is passed through to its shareholders) on a nonliquidating distribution of appreciated property as if it had sold the property for its fair market value (sec. 1363(d)). The purpose of this rule is to

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ment obligation if the obligation is distributed in a section 332 liquidation of a controlled subsidiary into its parent and the parent takes a carryover basis under section 334(b)(1).

[69] *See* secs. 311(d)(2)(A), 302(b)(4), (e). TEFRA added a provision that grants regulatory authority to prevent circumvention of the repeal of special tax treatment for partial liquidations through the use of section 355, 351, or 337, or other provisions of the Code or the regulations. Sec. 346(b).

[70] As previously noted, the original motivation for the relief was apparently to avoid the necessity of making the often difficult factual determination of who (the shareholders or the corporation) actually effectuated the sale, and to avoid the perceived unfairness of having tax consequences turn on such formalistic distinctions.

assure that the appreciation does not escape tax entirely. A shareholder in an S corporation generally does not recognize gain on receipt of property from the corporation, but simply reduces his basis in his stock by the fair market value of the property, taking a basis in the property equal to that value. The shareholder can then sell the property without recognizing any gain. Thus, unless the distribution triggered gain at the corporate level, no current tax would be paid on the appreciation in the distributed property.

Liquidating distributions by an S corporation are taxed in the same manner as liquidating distributions of C corporations. Thus, no gain is recognized by the corporation (sec. 1363(e)). Although the *General Utilities* rule in this context is not responsible for the imposition of only a single, shareholder-level tax on appreciation in corporate property,[71] it may allow a portion of the gain that would otherwise be ordinary to receive capital gains treatment.

Statutory law and judicial doctrines affecting application of General Utilities rule

Recapture rules

The nonrecognition provisions of sections 311, 336, and 337 are subject to several additional limitations beyond those expressly set forth in those sections. These limitations include the statutory "recapture" rules for depreciation deductions, investment tax credits, and certain other items that may have produced a tax benefit for the transferor-taxpayer in prior years.[72]

The depreciation recapture rules (sec. 1245) were enacted as part of the Revenue Act of 1962. They require inclusion, as ordinary income, of any gain attributable to depreciation deductions previously claimed by the taxpayer with respect to "section 1245 property"—essentially, depreciable personal property—disposed of during the year,[73] to the extent the depreciation claimed exceeds the property's actual decline in value. The 1962 Act also added a provision requiring recapture of amounts claimed as investment credits on premature dispositions of property for which a credit was claimed (sec. 47).

Congress has applied a more limited depreciation recapture rule to certain real estate. Under section 1250, gain on disposition of residential real property held for more than one year is recaptured as ordinary income to the extent prior depreciation deductions exceed depreciation computed on the straight-line method (sec. 1250). Gain on disposition of nonresidential real property held for more than one year, however, is generally subject to recapture of all depreciation unless a straight line method has been elected, in which case there is no recapture.[74]

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[71] A shareholder would under the subchapter S rules be entitled to a basis increase equal to the amount of gain recognized by the corporation.

[72] These rules apply not just to corporate distributions but to sales and other dispositions of property, other than in tax-free reorganizations.

[73] In the case of sales or exchanges of property in taxable transactions, the recapture rules convert a portion of what would otherwise be capital gain into ordinary income. In the case of nonrecognition transactions, the recapture rules require recognition of gain that would otherwise go unrecognized.

[74] Sec. 1245(a)(5).

A number of other statutory recapture provisions may apply to a liquidating or nonliquidating distribution of property, including section 617(d) (providing for recapture of post-1965 mining exploration expenditures), section 1252 (soil and water conservation and land-clearing expenditures), and section 1254 (post-1975 intangible drilling and development costs).

Collapsible corporation rules

Section 341 modifies the tax treatment of transactions involving stock in or property held by "collapsible" corporations. In general, a collapsible corporation is one the purpose of which is to convert ordinary income into capital gain through the sale of stock by its shareholders, or through liquidation of the corporation, before substantial income has been realized.

One of the principal abuses the collapsible corporation rules were intended to address was the acquisition or production by a corporation of assets that rapidly increased in value, primarily through the efforts of the corporation, followed by a liquidating distribution of those assets to shareholders before the corporation had recognized any significant amount of taxable income from the assets. The shareholders would take a stepped-up, fair market value basis in the distributed property at the price of a single, shareholder-level capital gains tax.

Alternatively, the shareholders could sell their stock to a third party, who would take a stepped-up basis in the property,[75] or the corporation could sell the property pursuant to a section 337 plan of liquidation. In either case, only a single capital gains tax at the shareholder level would have been paid on the appreciation in the property.

Under section 341, if a shareholder disposes of stock in a collapsible corporation in a transaction that would ordinarily produce long-term capital gain, the gain is treated as ordinary income. Likewise, any gain realized by a shareholder on a distribution of appreciated property from a collapsible corporation will be ordinary income. Finally, section 337 is inapplicable in the case of a collapsible corporation. Thus, sales of appreciated inventory or other property held by the corporation for sale to customers generate ordinary income which is fully recognized at the corporate level.[76]

Certain stock purchases treated as asset purchases

Section 338 of the Code, added by TEFRA, permits a corporation that purchases a controlling stock interest in another corporation (the "target" corporation) to elect to treat the transaction as a purchase of the assets of that corporation for tax purposes. If the election is made, the target is treated as if it had sold all of its assets pursuant to a plan of complete liquidation under 337 on the date of the stock purchase, for an amount equal to the purchase price of its stock plus its liabilities. Accordingly, no gain is recognized on the deemed sale other than gain attributable to section 1245 or other provisions that override section 337. The target is then treated as a newly organized corporation that purchased all of the "old" target's assets for a price equal to the purchase price of the stock plus the old target's liabilities on the day after the stock purchase. Thus, the new target corporation may obtain a stepped-up basis in its assets equal to their fair market value.

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[75] This step-up could be achieved in a liquidation of the acquired corporation under sections 332 and 334(b)(2) prior to TEFRA, or through a section 338 election after TEFRA. Section 338 is discussed further below.

[76] Gain on sales of capital or section 1231 assets in a section 337 liquidation of a collapsible corporation may be taxed at capital gains rates. A sale in liquidation may produce corporate level income that eliminates the collapsible status of the corporation, so that the shareholders will receive capital gains treatment on relinquishment of their shares in the liquidation.

Prior to the enactment of section 338, this same result could be achieved under sections 332 and 334(b)(2) by liquidating the acquired corporation into its parent within a specified period of time. One abuse Congress sought to prevent in enacting section 338 was selective tax treatment of corporate acquisitions. Taxpayers were able to take a stepped-up basis in some assets held by a target corporation or its affiliates while avoiding recapture tax and other unfavorable tax consequences with respect to other assets.[77] Section 338 contains elaborate "consistency" rules designed to prevent selectivity with respect to acquisitions of stock and assets of a target corporation and members of its affiliated group by an acquiring corporation and its affiliates. All such purchases by the acquiring group must be treated consistently as either asset purchases or stock purchases if they occur within the period beginning one year before and ending one year after the acquisition of the target corporation's stock.[78]

Sections 446 and 482

Under present law, it is unclear to what extent the clear reflection of income requirement of section 446(b) may override the *General Utilities* rule. In one case, it was held that the Commissioner could, pursuant to his authority under section 446(b), require construction companies which used the completed contract method of accounting and which liquidated before the contracts were completed to switch to the percentage of completion in the year of the liquidation, hence recognizing income.[79]

Similarly, it is unclear whether the Commissioner's authority under section 482 to reallocate income and deductions among commonly controlled organizations can be exercised to require recognition of gain on liquidating distributions to a parent corporation. For example, in *General Electric Co.* v. *United States*,[80] the court ruled that a loss sustained by a parent corporation on a sale of property distributed to it in a complete liquidation of a subsidiary under section 332 could be reallocated under section 482 to the subsidiary. Other cases, however, have held to the contrary.[81]

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[77] Prior to TEFRA, a step-up could be achieved through a partial liquidation of the target as well as a complete liquidation under sections 332 and 334(b)(2).

[78] Exceptions are provided for assets acquired in the ordinary course of business, acquisitions in which the basis of property is carried over, and other asset acquisitions as provided in regulations.

[79] *Standard Paving Co.* v. *Commissioner*, 190 F.2d. 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951).

[80] 83-2 U.S.T.C. para. 9532 (Cl.Ct. 1983).

[81] *Compare* Rev. Rul. 77-83, 1977-1 C.B. 139 (sec. 482 may override sec. 311) *with Bank of America* v. *United States*, 79-1 U.S.T.C. para. 9170 (N.D. Col. 1978) (holding to the contrary).

Liquidation-reincorporation transactions

The *General Utilities* rule is responsible at least in part for the use of a tax avoidance device known as liquidation-reincorporation. This device can take one of several forms, including (1) a complete liquidation of a corporation, followed by a transfer of all or a part of the operating assets to a new corporation organized by the shareholders, (2) a drop-down of all or part of the assets to a newly created subsidiary followed by a liquidation of the transferor corporation, or (3) a sale of all or part of the assets to a sister corporation followed by a liquidation of the selling corporation. The objectives of a liquidation-reincorporation transaction include bailing out the corporation's accumulated earnings and profits at capital gains rates and obtaining a stepped-up basis in the corporation's operating assets (again, at the price of only a single, shareholder-level capital gains tax by virtue of section 336 or 337), while continuing the business in corporate form.

The Internal Revenue Service has been successful in attacking some liquidation-reincorporation transactions by treating them as reorganizations, with any assets transferred to the new corporation taking a carryover basis. Assets retained by the shareholders are treated as "boot," generally taxable as a dividend if there is shareholder gain.[82] Amendments to section 368 made by the Tax Reform Act of 1984 liberalized the control requirement of section 368(c), thus making it easier for a liquidation-reincorporation to qualify as a nondivisive "D" reorganization.

The Internal Revenue Service and the courts have also applied the step-transaction and substance-over-form doctrines to liquidation-reincorporations.[83] Nonetheless, under some circumstances it may still be possible to achieve the tax benefits associated with a liquidation-reincorporation transaction.

Other judicially created doctrines

The courts have applied other nonstatutory doctrines from other areas of the tax law to in-kind distributions to shareholders. For example, it has been held that where the cost of property distributed in a liquidation or sold pursuant to a section 337 plan of liquidation has previously been deducted by the corporation, the tax benefit doctrine overrides the statutory rules to cause recognition of income.[84] The application of the tax benefit doctrine is, however, somewhat uncertain, turning on whether there is a "fundamental inconsistency" between the prior deduction and some subsequent event.[85]

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[82] *See, e.g., James Armour, Inc.* v. *Commissioner*, 43 T.C. 295 (1965) (sale of all operating assets of one corporation to a sister corporation owned by same shareholders in same proportions; *held*, transaction was in substance "D" reorganization combined with a boot dividend under sec. 356(a)(2)).

[83] *See, e.g.*, Rev. Rul. 61-156, 1961-2 C.B. 62; *Telephone Answering Service, Inc.* v. *Commissioner*, 63 T.C. 423 (1974), *aff'd* in unpublished opin. (4th Cir., November 8, 1976) *cert. denied*, 431 U.S. 914 (1977).

[84] *See, e.g., Bliss Dairy* v. *United States*, 460 U.S. 370 (1983) and *Tennessee Carolina Transportation, Inc.* v. *Commissioner*, 65 T.C. 440 (1975), *aff'd* 582 F.2d 378 (6th Cir. 1978) (liquidating distribution of previously expensed items); *Estate of Munter* v. *Commissioner*, 63 T.C. 663 (1975) (sale of previously deducted items pursuant to plan of liquidation).

[85] *Bliss Dairy, supra.*

The courts have also applied the assignment of income doctrine to require a corporation to recognize income on liquidating and nonliquidating distributions of its property.[86]

Administration Proposal

Neither the Administration's proposal nor the 1984 Treasury Report makes specific recommendations relating to the *General Utilities* rule. However, the Treasury Department in its 1984 Report expressed support for current efforts to simplify and rationalize the tax laws relating to the taxation of corporations and shareholders, including those relating to corporate liquidations.[87] The Administration's proposal to treat depreciable business assets ("sec. 1231 property") as ordinary income assets suggests that consideration be given to making the recapture rules for real property parallel to those applicable to personal property.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

Under the Bradley-Gephardt bill (sec. 416), gain would be recognized to a corporation on nonliquidating distributions of property (other than debt of the corporation) with respect to its stock. Gain would be recognized to a corporation on liquidating distributions of property, except where its basis in the property carries over to the distributee under section 334. Section 337 would be repealed. These amendments would be effective for transactions after 1986.

The collapsible corporation rules would be repealed for taxable years beginning after 1986 (sec. 241).

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill (sec. 412) would likewise require recognition of gain to the corporation on liquidating and nonliquidating distributions of property, with the same exceptions provided under the Bradley-Gephardt bill. Section 337 would also be repealed. These amendments would be effective for transactions after 1985.

H.R. 1377 and S. 556 (Stark-Chafee)

Under the Stark bill, 20 percent of the gain would be recognized to the distributing or selling corporation on distributions or sales of property in liquidation. The Chafee bill would require recognition of 15 percent of such gain. These amendments would be effective for distributions or sales after 1985 and before 1990.[88]

"Hostile" takeover situations

Several bills have been introduced that would limit the applicability of the *General Utilities* rule in a narrow set of circumstances.

H.R. 1003 and S. 420 (Jones-Boren).—H.R. 1003 and S. 420 would deem an acquiring company to have made a section 338 election if it acquires 80 percent or more of the stock of another corporation in a "hostile" takeover. Moreover, unlike under present law section 338, section 337 would not apply to the deemed sale of the target's assets and all gain would be recognized.

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[86] *E.g., Commissioner* v. *First State Bank*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948) (a decision rendered prior to the enactment of sec. 311); *Siegel* v. *United States*, 464 U.S. 891 (1972), *cert. dism'd*, 410 U.S. 918 (1973).

[87] 1984 Treasury Report, Vol. II, p. 144.

[88] Secs. 1602, 1612.

S. 632 (Chafee).—S. 632 would also make the section 338 election mandatory and deny section 337 relief in hostile takeover situations. In addition, S. 632 would not permit the acquiring corporation to treat as part of its purchase price (or as part of the basis of the assets deemed to have been acquired) the tax liability of the acquired corporation attributable to the deemed sale.

Senate Finance Committee staff proposal

The staff of the Senate Finance Committee recently published its final report to the Committee on the reform of the provisions relating to the taxation of corporations and shareholders.[89] Among its recommendations is the repeal of the *General Utilities* rule. Thus, under the staff's proposal, a corporation would be required to recognize gain on essentially all nonliquidating distributions and liquidating sales and distributions of its assets. Gain would be recognized to the extent the sales price or fair market value of the assets exceeded their basis. Losses would be recognized on liquidating distributions or sales. Exceptions to these recognition rules would be provided for distributions in which the distributee's basis is a carryover basis under section 334(b) and for certain distributions of stock in a five-year subsidiary.[90]

The collapsible corporation rules (sec. 341) would be repealed under the Finance Committee staff's proposal.

Analysis

Overview

The theoretical and policy underpinnings of the *General Utilities* rule have been intensely debated since the Supreme Court rendered its somewhat ambiguous decision in 1935. The codification of the rule did little to silence this debate. As noted in the previous section, since codifying the rule in 1954 Congress has been forced to reexamine it on several occasions because of perceived abuses, and the applicability of the rule has been gradually eroded. What is left is essentially a rule that permits a corporation to make liquidating distributions and liquidating sales of appreciated property (and narrowly circumscribed types of dividend distributions) without recognizing gain other than recapture amounts.

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[89] Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985* (S. Prt. 99-47), May 1985.

[90] The Senate Finance Committee staff proposal to repeal the *General Utilities* rule is integrally related to another Senate Finance Committee staff proposal directed at the tax consequences of one corporation's acquisition of a substantial portion of the stock or assets of another corporation. This staff proposal would make the corporate level tax consequences of such an acquisition elective, and would make these consequences independent of the consequences at the shareholder level. Under the staff's proposal, an acquiring corporation could elect to treat a qualified acquisition of stock as a purchase of assets (in which case the target would recognize gain and take a new cost basis in its assets), even though the transaction constitutes a nonrecognition transaction for the target's shareholders because they receive stock in the acquiring corporation. Under present law, a cost basis is not generally obtainable without recognition of gain at the shareholder level (even though such gain may be capital gain) because the section 338 election cannot be made if the transaction constitutes a tax-free reorganization. In order to assure continuation of this symmetry — that a stepped-up basis cannot be achieved without a tax being collected at some level — while permitting separation of corporation and shareholder level consequences (a principal aspect of the proposal), the repeal of the *General Utilities* rule would be essential. A special rule would allow nonrecognition by the transferor corporation (and require a carryover basis) with respect to goodwill and other unamortizable intangibles. As noted above, the staff's proposal would repeal *General Utilities* in the context of liquidations as well as acquisitions, with certain exceptions.

There has developed a relatively broad consensus, though by no means unanimity, among tax scholars and practitioners that the *General Utilities* rule even in its more limited form may produce arbitrary results, distort business behavior, and inject an inordinate amount of complexity (and, with it, controversy) into the tax system. While conceding some of these deficiencies, opponents of repeal argue that a rigid application of the two-tier tax to liquidating distributions is unwise and inappropriate, particularly in situations where the gain is attributable to long-held business assets and where small businesses, which may have less flexibility to avoid liquidations, are involved.

The principal arguments for and against the repeal of the *General Utilities* rule are discussed in greater detail below.

Arguments for repeal of General Utilities rule

Elimination of incentives for churning of assets and corporate takeovers

Proponents of repeal argue that the *General Utilities* rule creates artificial incentives for transfers of depreciable assets. An acquiring corporation is able to obtain a basis in assets equal to their fair market value without the transferor recognizing gain, except possibly recapture amounts. The tax deductions available under the Accelerated Cost Recovery System may make the assets more valuable in the hands of the transferee than in the hands of the present owner, even taking into account recapture taxes. Thus, the *General Utilities* rule may be responsible in part for the increase in corporate mergers and acquisitions.[91]

Elimination of bias in favor of liquidating distributions

Critics of the *General Utilities* rule also point out that it may encourage liquidations. By granting liquidating distributions more favorable treatment than distributions by ongoing corporations, it creates a bias in favor of corporate liquidations. These critics argue that economically, a liquidating distribution is indistinguishable from a nonliquidating distribution, and the two should not be treated differently for tax purposes.

Preservation of integrity of the corporate tax

Proponents of repeal of the *General Utilities* rule argue that the rule undermines the integrity of the corporate income tax by allowing assets to take a stepped-up basis without the imposition of a corporate-level tax. The *General Utilities* rule, they note, is a complete exception to general tax principles. Other nonrecognition provisions of the Code generally require a carryover basis in transferred assets as the price of nonrecognition, thus assuring that a tax will eventually be collected on the appreciation. The *General Utilities* rule grants a complete exemption from the tax on this gain at the corporate level by permitting a basis step-up at the price of, at most, a single, shareholder-level capital gains tax. Moreover, in some cases, this capital gains tax is not even collected immediately because the shareholder's gain is reported under the installment method. Yet the purchaser is entitled to an immediate step up to the full purchase price.

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[91] Additional discussion of the *General Utilities* rule in the context of mergers and acquisitions appears in Joint Committee on Taxation pamphlets *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85) March 29, 1985, and *Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (and S. 420, S. 476 and S. 632)* (JCS-9-85) April 19, 1985.

Reduction of complexity and uncertainty of tax consequences

Proponents of repeal contend that repealing sections 311, 336, and 337 would significantly simplify the corporate tax provisions of the Code. These provisions have evolved into an elaborate statutory framework with numerous definitions, limitations, and exceptions. Repeal of the *General Utilities* rule would also promote simplification by making the complex collapsible corporation rules unnecessary. Since all corporations would be taxed on distributions or liquidating sales of appreciated property, the ability of taxpayers to achieve the "bailout" that section 341 is intended to prevent would largely be eliminated.[92]

Finally, critics of the rule argue that repeal would eliminate a large and confusing body of case law and rulings that have attached to these provisions, and improve certainty of tax consequences. For example, at least in this context, the Internal Revenue Service would not have to invoke the liquidation-reincorporation, tax benefit, assignment of income, or clear reflection of income doctrines, or section 482, in an effort to prevent perceived abuses resulting from distributions of appreciated property.

Arguments against repeal

The General Utilities rule provides relief from double taxation of corporate income

Defenders of the *General Utilities* rule argue that it acts as a relief measure against double taxation of corporate gains when extraordinary events occur in the life of a corporation. They note that the Federal income tax system has never been a pure two-tier system of taxation, but rather a partially integrated one. Only a single-level tax has historically been imposed on sales or distributions of corporate assets in a liquidation. Furthermore, as a practical matter, there are numerous exceptions to the two-tier tax even outside a liquidation context. Some businesses may avoid having earnings taxed at two levels through various tax-planning techniques, such as paying out earnings as "salaries" to shareholder-employees rather than as dividends. In any event, opponents of repeal contend, the corporate tax was principally designed to reach corporate operating profits. The gains that would be taxed by repealing *General Utilities* would largely be inflationary or investment gains. Taxing income from investment more heavily would inhibit capital formation, lock in investments, and generally have adverse effects on the economy.

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[92] Even if the original shareholders sold their stock at capital gains rates, the corporate level tax on the gain would be preserved and would be imposed when the corporation sold the property in the course of its business or liquidated.

Disproportionate impact on small businesses

Opponents of repeal argue that the burden of repeal would fall primarily on small, family-owned businesses. Large, publicly held companies might seldom bear the double tax because such companies may rarely liquidate entirely. Rather, they more typically may merge into other large companies in tax-free reorganizations. Small businesses, on the other hand, have less flexibility to avoid the two-level tax through a merger. Yet such businesses present a more sympathetic case than the large public corporation, they argue. Frequently the small business will hold assets such as land, acquired from its original shareholders or their descendants, that have appreciated over a long period of time. Often these same shareholders will hold the corporation's stock at the time of the proposed liquidation. Thus, repeal of *General Utilities* would mean these small businesses will pay a double tax on the (largely inflationary) gain on their property. Alternatively, closely-held companies will be pressured to merge into larger companies rather than liquidate.

Opponents of repeal also argue that in the future, the effect of repeal would be to create a strong disincentive for incorporations of small businessess, when the corporate form may otherwise be the most appropriate method of carrying on business.

Repeal of the General Utilities rule would not reduce complexity

In response to claims that repeal would simplify the Code, opponents of repeal argue that exceptions to the recognition requirement would very likely be enacted and new complexities would inevitably result.

Additional discussion, issues, and possible proposals

The debate over the *General Utilities* rule has been related to the controversy over whether the corporate and individual income taxes should be integrated.[93] The Federal income tax system is at least nominally a double tax system. Congress first imposed the corporate tax in 1909 and has taxed corporate income separately ever since; the individual tax was first imposed in 1913.[94] Although Congress has ameliorated the impact of the double tax in indirect ways, for example, by various deductions and credits that reduce the effective corporate rate below the nominal rate, a two-tier tax system generally remains intact.

The *General Utilities* rule is sometimes defended as a de facto system of partial integration that Congress has adopted to temper the otherwise harsh consequences of the double tax. There are several responses to this argument. First, if the rule constitutes a

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[93] For a discussion of some proposals with respect to partial integration, see Part II, *supra*.

[94] The corporate tax initially was 1 percent of net income in excess of $5,000. Since there was no tax on individual income at that time, the double tax phenomenon did not exist. Even when the individual tax was enacted in 1913, it imposed a tax of only 1 percent on net incomes of individuals above $3,000 ($4,000 for married persons). A surtax of 1 percent was imposed on incomes above $20,000, rising to a rate of 6 percent for incomes above $500,000.

"system," it is an arbitrary and irrational one to the extent it accords different tax treatment to economically similar transactions such as liquidating and nonliquidating distributions. Second, there is little evidence that the codification of the *General Utilities* rule was a deliberate effort to mitigate the impact of the double tax. On the contrary, it appears Congress believed it was merely codifying prior law, and may have done so without a full understanding of the issues.[95] Finally, assuming Congress believes a system of partial or complete integration is desirable as a matter of tax or economic policy, a more direct approach may be more equitable and efficient. The dividends paid deduction proposed by the Administration[96] would be one direct method of establishing a system of partial integration.

If the two-tier tax system is to be retained, many have questioned preserving the *General Utilities* rule. The rule permits complete avoidance of the corporate level tax on liquidating distributions and permits a step-up in basis to the transferee at the price of a single, shareholder-level capital gains tax. The tax collected at the shareholder level in many instances will bear no relationship to the tax that would have been collected at the corporate level, since the amount of gain and tax rates at the two levels may differ significantly. Furthermore, the rule in conjunction with other provisions of the tax law may result not only in avoidance of tax at the corporate level, but in complete avoidance of tax. This may occur, for example, where a distribution of property or liquidation proceeds is to a shareholder who received his stock from a decedent, and hence has a fair market value basis in the stock under section 1014. Alternatively, the shareholder may be a tax-exempt entity or a foreign person not subject to U.S. tax.

Even in its present, more limited form, the *General Utilities* rule has presented opportunities for taxpayer planning to avoid recognition of gains while recognizing losses at the corporate level. For example, taxpayers have been successful in selling their depreciated assets outside of section 337, thereby recognizing the losses, while selling appreciated assets under the protection of section 337.[97]

Finally, it is difficult to avoid the conclusion that the *General Utilities* rule may tend to influence business behavior. As previously illustrated, present law provides significant incentives for acquisitions or liquidations of corporations whose assets have substantially appreciated, since a sale of the assets in the ordinary course of business would trigger tax at the corporate level. Churning of corporate assets is encouraged by the fact that an acquiring corporation can obtain a fair market value basis in the appreciated assets of another corporation without the latter recognizing gain to the extent of the appreciation. Although the selling corporation's shareholders will recognize gain on the liquidation, the gain may be deferred in whole or in part through use of the installment method. The purchaser obtains a full step up in basis for the assets regardless of the amount of gain reported currently by the shareholders.

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[95] The minority party report to the 1954 Code states observes that "[d]ue to the complexity of [the Subchapter C provisions] . . . , time has not permitted us to more than analyze these sections on their surface." H.R. Rep. No. 1337, 83d Cong. 2d Sess., B19.

[96] See discussion in Part II, *supra.*

[97] *See, e.g., Virginia Ice and Freezing Corp.* v. *Commissioner*, 30 T.C. 1251 (1958); *City Bank of Washington* v. *Commissioner*, 38 T.C. 713 (1962). Similarly, taxpayers may attempt to distribute appreciated assets in liquidation and avoid corporate level tax on the appreciation, while selling loss assets outside the 12 month section 337 period and recognizing losses.

Accordingly, repeal of the *General Utilities* rule could be viewed as constituting a major step towards eliminating tax incentives to corporate acquisitions and mergers.

Relief measures

Some have suggested that if the *General Utilities* rule were repealed, it would be necessary, or at least appropriate, to provide relief from the double tax in certain cases. For example, relief might be provided on the basis of the type and holding period of the property and the size of the corporation involved. As noted above, the rule has been justified as a mechanism for avoiding a double tax on appreciation in assets held by a corporation that are largely investment or inflationary gains. Accordingly, it has been suggested that relief be provided only with respect to gains attributable to capital assets held by a corporation for a relatively long period of time. Such relief could be given to all corporations or, consistent with the argument that closely-held businesses are more likely to be adversely affected by repeal, might be limited to dispositions of such assets by small businesses.[98]

Relief could take one of several forms, including an exemption from tax at the corporate level,[99] an exemption from or deferral of tax at the shareholder level, or a shareholder credit for taxes incurred by the corporation on disposition of the property. Under the shareholder credit approach, the credit would be applied by the shareholder against the tax payable on the sale of his stock.[100] In its report, the staff of the Senate Finance Committee recommends adoption of a variation of the shareholder credit approach, but would confine this relief to acquisitions or liquidations involving certain small businesses. The shareholder would be allowed to increase the basis in stock in the corporation to reflect the corporate level tax on long-held capital assets. In addition, the staff proposal would permit shareholders of any corporation (not just small businesses) that liquidates in kind to defer the shareholder level tax with respect to property, other than cash, stock, securities, or similar property, distributed in liquidation. This would involve a substitute basis election similar to that contained in section 333 of present law.

Critics of these relief proposals argue that creating permanent relief provisions for certain businesses and assets would simply create new biases, distortions, and complexities in the tax system.

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[98] The final report of the Senate Finance Committee staff recommends the latter approach, confining relief to businesses with a fair market value of $1 million or less, for capital assets held for five years or longer. Decreasing partial relief would be provided for corporations up to $2 million in value.

[99] *See, e.g., General Utilities* Task Force Report, "Income Taxation of Corporations Making Distributions with Respect to Their Stock," 37 *Tax Law.* 625 (1984). This proposal by the ABA Tax Section Task Force would provide an exemption from the corporate tax for liquidating distributions of "historic" capital assets and section 1231 assets held for more than 3 years; for sales of such assets pursuant to a plan of liquidation; for sales and distributions of goodwill and other nonamortizable intangibles; and for distributions of controlled subsidiary stock.

[100] *See* American Law Institute, *Federal Income Tax Project: Subchapter C*, 134-131 (1982).

The arguments that the complete repeal of *General Utilities* would have some undesirable collateral effects on capital formation and the economy or would discourage use of the corporate entity are, they contend, largely unsubstantiated, as are arguments that small businesses would suffer most from repeal. Any potential inequities resulting from repeal could be addressed by providing liberal transition relief and phase-in rules. If Congress wishes to encourage small business or promote other social policies, these critics argue, there are better alternatives than using the tax Code. (Even within the tax Code, they contend, there are better, more direct alternatives such as further reductions in the graduated rate schedules.) If an unintegrated, two-tier system of taxation is deemed to be too harsh, Congress should provide relief in the form of full or partial integration on a nondiscriminatory basis.

Impact of repeal on other provisions of Code

Repeal of the *General Utilities* rule may create additional pressure for taxpayers to bring acquisition and liquidation transactions within the tax-free reorganization provisions of the Code. Furthermore, investors and entrepreneurs may resort to partnerships or other pass-through entities as vehicles for carrying on business. If this occurs, additional strain may be placed on the provisions of the Code relating to reorganizations, classification of entities, and taxation of pass-through entities. Congress may find it necessary to reexamine these provisions to assure that they are operating rationally and efficiently, and do not present opportunities for tax avoidance.

Alternatives to complete repeal

If Congress decides that a complete repeal of the *General Utilities* rule is unwarranted, it may wish to consider eliminating the nonrecognition treatment under section 336 for all liquidating dispositions of ordinary income assets, and repealing the remaining exceptions to recognition under section 311. In the hearings conducted by the Senate Finance Committee in 1983,[101] none of the witnesses advocated permanent relief for dispositions of assets outside a liquidation context. Furthermore, it has been contended that there is no logical basis for exempting inventory, whether or not sold in bulk, or other assets held for sale to customers in the ordinary course of business. Congress might also consider amendments to section 337 that would make "straddles" of that provision—that is, selective recognition of losses on depreciated assets without recognition of gain on appreciated assets—more difficult.

A more limited solution to the *General Utilities* problem would be to tighten the recapture provisions of the Code. For example, section 1250 could be modified to require that upon disposition of section 1250 property, an amount equal to the excess of depreciation claimed over the economic decline in value must be recognized as ordinary income to the transferor even if depreciation has been taken on a straight-line basis. This would conform the rules for depreciable real property with those for depreciable personal proper-

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[101] "Reform of Corporate Taxation," Hearing before the Committee on Finance, United States Senate, 98th Cong., 1st Sess. (October 24, 1983).

Continued

ty (sec. 1245).[102] In addition, gain on all mineral property could be included in income to the extent of previously deducted intangible drilling costs, regardless of whether deducted before or after 1976, or whether the deductions exceed what could have been recovered through depletion deductions had they been capitalized. Similarly, gain on all mineral property could be required to be included in income to the extent of prior depletion deductions allowed or, alternatively, to the extent percentage depletion deductions allowed with respect to such property exceed those that would have been allowed under cost depletion.

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[102] As previously noted, the Administration proposal states that consideration could be given to applying the limits imposed by the recapture rules on nonrecognition transactions, such as corporate liquidations, on a parallel basis with respect to real and personal property.

IV. ENTITY CLASSIFICATION

Present Law and Background

Classification as a partnership or corporation

Under present law, Treasury regulations provide that whether a particular entity is classified as an association taxable as a corporation or as a partnership, trust, or some other entity not taxable as a corporation is determined by taking into account the presence or absence of certain characteristics associated with corporations. These characteristics are (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for entity debts limited to entity property, and (6) free transferability of interests.[103] These regulations are generally based on the principle stated in *Morrissey* v. *Comm'r*, 296 U.S. 344 (1935), in which the Supreme Court held that whether an entity is treated as a corporation depends not on its formal organization but on whether it more closely resembles a corporate than a noncorporate entity.

Of the characteristics mentioned above, the first two are common to both corporate and noncorporate business enterprises. Consequently, the remaining four factors are determinative. Treasury regulations state the corporate characteristics of an entity must make it more nearly resemble a corporation than a partnership or a trust for the entity to be treated as a corporation.[104] Although *Morrissey* suggested evaluation on a case-by-case basis, the Treasury regulations, while allowing for the presence of other "significant factors," simply count the presence or absence of the four stated factors; if fewer than three are present, an entity is not treated as a corporation. In this respect, the regulation goes further than *Morrissey* by providing that where there are an equal number of the critical "corporate" and "noncorporate" characteristics, the entity will not be classified as a corporation.

Attempts to expand the inquiry regarding partnership or corporation classification have not been successful. Regulations proposed in 1977[105] would have tightened the test with respect to the continuity of life and centralized management factors, and generally would have required the examination of additional factors if an entity had two of the four corporate characteristics. The proposed regulations were intended as a response to criticism that the existing regulations deviated from the "resemblance test" on which they were based, as articulated by the Supreme Court in *Morrissey*. These proposed regulations were withdrawn one day after they were issued.

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[103] Treas. Reg. sec. 301.7701-2(a).

[104] *Id.*

[105] 42 *Fed Reg.* 1038 (Jan. 5, 1977).

In addition, consideration of factors other than the four primary ones was limited in *Larson* v. *Comm'r*, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1, in which the Tax Court held that a number of specified "other factors" were relevant only in evaluating the presence or absence of the four primary ones. The Internal Revenue Service later announced that it would follow *Larson*'s method of evaluating such other factors.[106] As a result, most limited partnerships formed under the Uniform Limited Partnership Act are not treated as corporations. These entities generally do not possess continuity of life and may often lack limited liability.[107]

Treatment of partnerships and grantor trusts

If as a result of the legal tests described above, an entity is classified as a partnership, it will generally be treated as a conduit for income tax purposes. The partnership itself will have no liability for tax and all items of income, expense, credit, etc., are allocated to and accounted for by the partners, including limited partners.

Similarly, if an entity is classified as a grantor trust, beneficiaries of the trust are treated as owners of a proportionate share of the trust's assets and account directly for the trust's items of income and expense. The grantor trust is often used, in a form known as a fixed investment trust, as a vehicle for the common ownership of investment assets. An example of such a trust is a so-called "mortgage pool," which involves the transfer of a group of mortgage loans to a trustee who holds the mortgages for the benefit of persons who have purchased or otherwise acquired interests in the trust.

Treatment of corporations

As discussed in Part II above, income earned by a corporation generally is subject to tax at the corporate level when earned and then subject to tax at the shareholder level when distributed. Nevertheless, several types of corporations are provided special exemption from this general scheme.

S corporations

In general, a corporation may elect to be treated under subchapter S of the Code (sec. 1361 *et seq.*) if it has 35 or fewer shareholders (none of whom are corporations or nonresident aliens), has not more than one class of stock, and is not a financial institution, a life insurance company, or one of several other types of corporations.

If such a corporation elects to be treated as subject to subchapter S, its shareholders generally account for a proportionate amount of the corporation's items of income, loss, deduction, and credit. The S corporation itself generally has no tax liability for so long as the election is in effect.

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[106] Rev. Rul. 79-106, 1979-1 C.B. 448.

[107] Continuity of life generally does not exist under the Uniform Limited Partnership Act even if partners agree in advance to continue the partnership upon the death or withdrawal of a general partner. Treas. Reg. sec. 301.7701-2(b). *See* Rev. Proc. 85-22, Sec. 3.41, I.R.B. 1985-12, 13. In addition, limited liability has been held to be absent even though the only partner with personal liablity is a corporation, unless the corporation *both* does not have substantial assets *and* is a mere "dummy" acting as the agent of the limited partners. *See Larson, supra*, 66 T.C. at 173-176, 179-182. The Internal Revenue Service has announced a study that will reconsider the acquiescence in *Larson* to the extent the acquiesence is inconsistent with the minimum capitalization requirement of Rev. Proc. 72-13, 1972-1 C.B. 735. Ann 83-4, I.R.B. 1983-2, 31.

Regulated investment companies

In general, to qualify as a regulated investment company ("RIC"), a corporation must be a domestic corporation that either meets or is excepted from certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its income from specified sources commonly considered investment income, that has a portfolio of investments which is sufficiently diversified, and that also meets certain other requirements. Mutual funds, for example, generally qualify as RICs.

If a corporation meets these requirements and elects to be treated as a RIC, it generally would be subject to the regular corporate tax, but would receive a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 90 percent of its ordinary income, including tax-exempt income. These dividends must be paid within a short period following the close of the RIC's taxable year and are generally includible as ordinary income to the shareholders.

A RIC that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the RIC pays dividends out of such capital gains, the dividends are deductible for the RIC in computing its capital gains tax and are taxable as capital gains to the recipient shareholders.

Real estate investment trusts

In general, an entity may qualify as a real estate investment trust ("REIT") if it is a widely held entity with freely transferable interests that would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being in substantial part realized from certain real estate and real estate related sources.

If these requirements are met and the entity elects to be taxed as a REIT, like a RIC it generally would be subject to the regular corporate tax, and generally would be permitted a deduction for dividends paid to its shareholders within a short period after the close of its taxable year provided it distributes at least 95 percent of its taxable income, excluding capital gains. The treatment of capital gains for a REIT and its shareholders is similar to that for a RIC.

Cooperatives

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the Code. In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities).

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one important exception—the cooperative may deduct from its taxable income patronage dividends paid. In general, patronage dividends are profits of the cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. This rebate may be in a number of different forms.

In general, cooperatives are permitted to deduct patronage dividends only to the extent of net income derived from transactions with its members. Thus, cooperatives generally are subject to corporate tax on profits derived from transactions with nonmembers.[108]

Members of the cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

Analysis

Although the general scheme under present law treats corporations and their shareholders as separate entities and imposes tax on each, there are numerous exceptions, as discussed above.

The main issue raised by the existence of these exceptions is that in many cases taxpayers, by carefully selecting the type of entity through which they will carry on a business or investment activity, may elect whether or not to subject the income of the entity to the corporate tax, even though the taxpayer benefits from the entity's possession of corporate characteristics. Since the Administration proposal in the aggregate would increase the amount of taxes raised from corporations, it is not clear whether more taxpayers would then be encouraged to "elect out" of the corporate tax by taking advantage of some other type of entity.

In addition, the existence of these different possibilities may raise concerns about the fairness of the tax system. In particular, numerous tax shelter activities take advantage of the ability of limited partners to have the protection of personal limited liability and yet receive the use of entity losses.

Several recent proposals have addressed this situation. The 1984 Treasury Report contained a proposal to treat limited partnerships that have more than 35 partners as corporations. A 1983 Senate Finance Committee Staff Report on the taxation of corporations included a recommendation that publicly traded limited partnerships be taxed as corporations.[109] The 1984 ALI Subchapter K Project[110] also proposed the taxation of publicly traded limited partnerships as corporations. These and other proposals are discussed in a separate Joint Committee pamphlet. [111]

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[108] In addition, if an entity qualifies as a tax-exempt farmers' cooperative under section 521(b) of the Code, it may generally deduct patronage dividends to the full extent of its net income and may also deduct, to a limited extent, dividends on its common stock. (See also note 11, Part II, *supra.*)

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[109] *See* Staff of the Senate Committee on Finance, 98th Cong., 1st Sess., *Report on the Reform and Simplification of the Income Taxation of Corporations* (S prt. 98-95), September 22, 1983, p. 80. The final report prepared by the Senate Finance Committee Staff (Senate Committee on Finance, *The Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff* (May, 1985)) contains no such recommendation, apparently because of the fact that when that report was prepared, the 1984 Treasury report had published its broader proposal and the staff determined not to approach the issue in a piecemeal manner.

[110] ALI, *Federal Income Tax Project—Subchapter K* (1984), p. 392.

[111] *See* Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985, pp. 38-41.

V. CERTAIN OTHER PROPOSALS

The statutory provisions that govern the tax treatment of corporations and their shareholders are found in Subchapter C (secs. 301-386). Subchapter C has been criticized on the grounds that certain provisions are overly complex and other provisions present unwarranted opportunities for tax avoidance. Certain proposals relating to the treatment of dividend distributions and the *General Utilities* doctrine have been discussed in Parts II and III above. This part of the pamphlet describes certain additional proposals.[112]

A. Corporate Distributions

In general, a corporation's earnings are taxed to its shareholders only upon distribution of those earnings. Dividend distributions are taxed to individual shareholders at a maximum rate of 50 percent. Individuals are taxed on long-term capital gains at a maximum rate of 20 percent.

A corporate shareholder is generally permitted to deduct 85 percent of the amount of dividends received from domestic corporations. Thus, because the maximum rate of tax on income received by a corporation is 46 percent, the maximum rate of tax on dividends received by a corporation is only 6.9 percent. A corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) is subject to an alternative tax of 28 percent if the the tax computed using that rate is lower than the corporation's regular tax. Accordingly, a corporate shareholder may prefer a distribution to be characterized as a dividend, while an individual shareholder may prefer characterization as a "sale" of stock eligible for long-term capital gains treatment.

1. Character of Nonliquidating Distributions

Present Law and Background

In general, the amount of a distribution otherwise qualifying as a dividend by a corporation to a shareholder is includible in the shareholder's gross income as a dividend only to the extent the distribution is made out of the corporation's current or accumulated earnings and profits (secs. 301(c)(1) and 316(a)). If the distribution exceeds the corporation's earnings and profits, the excess is applied against and reduces the basis of the shareholder's stock (sec. 301(c)(2)). To the extent such a distribution exceeds the basis of the stock, the excess is treated as gain from the sale or exchange of property (sec. 301(c)(3)).

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[112] For a proposal to revise subchapter C comprehensively, *see* Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985* (S. Prt. 99-47), May 1985. Additional corporate tax proposals relating to mergers and acquisitions are discussed in Joint Committee on Taxation pamphlets, *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85), March 29, 1985, and *Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (and S. 420, S. 476 and S. 632)* (JCS-9-85), April 19, 1985. Proposals relating to corporate net operating loss carryovers are discussed in Joint Committee on Taxation pamphlet, *Limitations on the Use of Net Operating Loss Carryovers and Other Tax Attributes of Corporations* (JCS-16-85), May 21, 1985.

The purpose of the earnings-and-profits limitation generally is stated to be the protection of returns of capital from the tax on dividends.[113] Earnings and profits are thus generally intended to be a measure of a corporation's economic income that is available for distribution to shareholders.[114] Commentators have suggested that the purpose of identifying returns of capital is not well served, primarily because of the formulation of earnings and profits and the failure to take all the economic aspects of a shareholder's investment into account.

There is no comprehensive statutory definition of the term "earnings and profits," nor does the term have a counterpart in the accounting or other areas. Indeed, the term may not lend itself to ready definition. The applicable statute and Treasury regulations merely describe the effects of specified transactions on a corporation's earnings and profits (sec. 312). The effects of other transactions have been addressed by the courts and the Internal Revenue Service; however, for many transactions the law is unclear as to whether earnings and profits should be adjusted.[115] Further, it is necessary to take account of numerous transactions over the life of a corporation, including, for example, mergers or consolidations with other corporations and dispositions of assets.

In many instances, a corporation may have economic income but no earnings and profits for tax purposes. In such a case, the corporate laws of most states would permit dividends to be paid, although such dividends would be treated as returns of capital under the Internal Revenue Code. For example, for purposes of computing earnings and profits, depreciation is computed on a straight-line basis over specified periods, producing a result that may bear no relation to an asset's actual loss in value. Economic income is understated to the extent that depreciation is accelerated relative to an asset's actual loss in value. The rate of depreciation that accurately reflects economic income is itself subject to considerable debate.

The present-law rules are also subject to manipulation. For example, assume that a corporation has current earnings and profits, but a deficit in accumulated earnings and profits. If the corporation were to distribute the current earnings and profits, the distribution would be treated as a dividend, notwithstanding the deficit in accumulated earnings and profits. Alternatively, if the corporation did not expect to realize earnings during the next taxable year, dividend treatment could be avoided by distributing the current earnings during the following year, as the only effect of the earnings after the end of the current year would be to reduce the deficit. Another example of the opportunities for tax avoidance is described in a 1983 report prepared by the staff of the Senate Finance Committee:

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[113] *See* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* 7-4 (4th ed. 1979).

[114] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 835 (1984) (Conference Report, *Deficit Reduction Act of 1984*).

[115] For a discussion of such issues, *see* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* 7-16 to 7-23 (4th ed. 1979). In other cases, the law is clear but the appropriate measure of economic income may be subject to dispute. Depreciation is one example. As another, earnings and profits are reduced by the full amount of research and experimental expenditures expensed under section 174. Some have contended that this rule may not reflect economic income because such expenses may create assets with useful lives extending beyond a year. Others contend it is difficult to relate such expenses to particular assets and that expensing is an appropriate measure.

Example.—X corporation has no earnings and profits but has substantial unrealized appreciation on a building it owns. X obtains a mortgage on the building and distributes the proceeds to its shareholders. The distribution by X to its shareholders is tax free as a return of capital or is taxed as capital gain. Subsequent corporate earnings can then be used to pay off the mortgage without tax on the shareholders.[116]

The determination of whether there are earnings and profits is made at the corporate level, without regard to whether stock has changed hands or to the circumstances of particular shareholders. Thus, if a distribution is made out of accumulated earnings and profits with respect to stock that was acquired for a price that reflected those earnings, the distribution is taxed as a dividend, even if the corporation realized no additional earnings after the stock was acquired. In such a case, from an economic perspective, the shareholder can be viewed as receiving a return of capital.

Possible Proposal

In view of the defects of present law, and the complexity involved in computing earnings and profits, numerous commentators have suggested that the earnings-and-profits limitation should be eliminated.[117] Without an earnings-and-profits limitation, all distributions would be taxed as ordinary income, except distributions in redemption of stock. Proponents of eliminating earnings and profits justify this treatment on the grounds that it would treat an equity investment in a corporation like most other investments, e.g., interest payments are ordinary income even though the principal of the debt may never be repaid. Further, as described above, the present-law rules often fall short of measuring a shareholder's economic income, particularly where the corporation's stock has changed hands.

The repeal of the earnings-and-profits limitation would not necessitate changes in the basic structure of other provisions relating to corporate distributions. For example, the rules for distinguishing redemptions from ordinary distributions could apply without amendment (sec. 302). Similarly, the rule for the treatment of nonqualified consideration in tax-free reorganizations could also apply with modifications (see also the proposal to eliminate the dividend-within-gain limitation, discussed in Part V.B.1., below).

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[116] Staff of Senate Committee on Finance, 98th Cong., 1st Sess., *Report on the Reform and Simplification of the Income Taxation of Corporations* (S. Prt. 98-95), September 22, 1983. For an example of this technique, *see Falkoff* v. *United States*, 604 F.2d 1045 (7th Cir. 1979).

[117] *See, e.g.*, Committee on Corporate Stockholder Relationships, American Bar Association, *Report on the Elimination of "Earnings and Profits" from the Internal Revenue Code* (the full text of which can be found in the August 12, 1985 Tax Notes Microfiche Data Base as Doc. 85-7217); Hearing before the Senate Committee on Finance, 98th Cong. (1983) (Statement of William D. Andrews); Staff of the Senate Committee on Finance, 98th Cong., 1st Sess., *Report on the Reform and Simplification of the Income Taxation of Corporations* (S. Prt. 98-75) September 22, 1983); Blum, "*The Earnings and Profits Limitation on Dividend Income: A Reappraisal*," 53 *Taxes* 68 (1975).

Opponents of repealing the earnings-and-profits limitation question whether it would be appropriate to tax all distributions as ordinary income and whether existing complexity would be reduced, since a similar concept would still be required for purposes of other statutory provisions. For example, the concept is used in determining the allowability of indirect foreign tax credits associated with dividends received from affiliated foreign corporations (sec. 902). Nevertheless, some commentators have suggested that it might be possible to formulate a less complicated standard of measure for other purposes if the dividend-definition aspect were eliminated.[118]

As an alternative to repeal of the earnings and profits limitation, consideration could be given to amending the definition of earnings and profits to more clearly reflect economic income or income available for distribution—including, for example, a modification in the treatment of depreciation for earnings and profits purposes.

2. Bail-Outs Through Use of Related Corporations

Present Law and Background

Section 304 is designed to prevent shareholders from bailing out corporate earnings at capital gain rates through the device of selling stock in one corporation to a related corporation. In general, the sale of stock by a shareholder to a related corporation is treated as a redemption, with the result that the sale proceeds are taxed to the shareholder as a dividend unless the transaction qualifies under the rules for distinguishing a redemption from an ordinary distribution. The application of section 304 to corporate shareholders can produces incongruous results by characterizing amounts as dividends that are eligible for the dividends received deduction which generally benefits corporate taxpayers. Furthermore, Congress has found it necessary to address a host of technical problems that would not have arisen if the scope of section 304 were limited to individual shareholders. Finally, the application of section 304 has unintended effects that are unrelated to the purpose of the provision.

In the case of "brother-sister" transactions, if one or more persons in control of one corporation transfer stock in that corporation to another controlled corporation, the transaction is treated as a redemption of the shareholders' stock in the acquiring corporation (sec. 304(a)(1)). In the case of "parent-subsidiary" transactions, the transaction is recast as a redemption of the stock of the parent corporation (sec. 304(a)(2)). In determining the tax consequences of the deemed redemptions, dividend treatment generally results unless the transaction results in the termination of or a substantial reduction in the selling shareholder's interest (sec. 302). Even if the selling shareholder is treated as having sold the stock, the acquiring corporation is deemed to have received the stock as a contribution to capital (with the result that the corporation's basis in the stock is determined by reference to the basis in the hands of the shareholder, not the corporation's purchase price).

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[118] Hearing before the Senate Committee on Finance, 98th Cong. (1983) (Statement of William D. Andrews).

The predecessor of section 304 (sec. 115(g) of the 1939 Code) was enacted in response to judicial decisions that permitted noncorporate taxpayers to avoid the ordinary income tax rates applicable to dividends by selling the stock of a controlled corporation to the corporation's subsidiary.[119] The House version of the original legislation limited the provision to cases in which "individuals" sold stock to related corporations. The Senate bill extended the provision to stock sales by corporations. The committee report that accompanied the Senate bill does not offer an explanation for this change.

The legislative history of the 1954 Code, which expanded the scope of the provision to include the sale of stock in one corporation to a commonly controlled corporation, indicates that the provision is intended to prevent tax avoidance.[120] In the case of individuals, section 304 discourages the prohibited transactions by treating what would be capital gain as dividend income. For corporations, however, dividends eligible for the dividends received deduction may be taxed significantly more lightly then capital gains. Thus, it is unclear what purpose is served by applying section 304 to corporate shareholders.

The application of section 304 to C corporations has engendered a number of technical corrections and other amendments that add to the complexity of the Code. For example, the Deficit Reduction Act of 1984 contained amendments that are designed to prevent the use of section 304 by corporations (1) to shift earnings and profits among members of controlled groups of corporations, and thereby create an opportunity to make nondividend distributions to noncorporate shareholders, and (2) to circumvent other statutory provisions that recharacterize gain on sale of stock in certain controlled foreign corporations as dividends that are ineligible for the dividends-received deduction.[121]

Possible Proposal

Consideration could be given to making section 304 inapplicable to the transfer of stock by corporate shareholders. In addition, where a selling shareholder is treated as having sold stock, the acquiring corporation could be treated as having purchased the stock. The latter proposal was included in the 1959 report submitted by the Advisory Group on Subchapter C to the House Committee on Ways and Means.[122]

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[119] *See* H.R. Rep. No. 2319, 81st Cong., 2d Sess. 53 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 43 (1950). *See also Commissioner* v. *Wanamaker*, 11 T.C. 365 (1948), *aff'd per curiam*, 178 F.2d 10 (3rd Cir. 1949) (which involved a stock sale by trustees of a testamentary trust and is cited in the 1950 committee reports).

[120] *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. 37 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 45 (1954). *See also Commissioner* v. *Pope*, 239 F.2d 881 (lst Cir. 1957) (which involved a stock sale by an individual, between commonly controlled corporations).

[121] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 1222-1224 (1984) (Conference Report).

[122] *See* Hearings before the House Committee on Ways and Means, 86th Cong. (1959), *Revised Report on Corporate Distributions and Adjustments*, prepared by the Advisory Group on Subchapter C.

B. Tax-Free Corporate Organizations and Reorganizations

The corporate organization and reorganization provisions provide tax-free treatment to specifically described transactions that effect a readjustment of continuing interests in property in modified corporate form. For purposes of these nonrecognition provisions, qualified consideration is defined as stock or securities; anything else is "boot" that generally triggers taxable gain (but not deductible loss).

1. Dividend-Within-Gain Limitation on Boot Dividends

Present Law and Background

Generally, no gain or loss is recognized by shareholders or security holders who exchange stock or securities solely for stock or securities in a corporation that is a party to the reorganization (sec. 354(a)(1)). If the exchange also involves the receipt of nonqualifying consideration, gain is recognized up to the amount of the boot. Further, part or all of that gain may be taxed as a dividend if the exchange has the effect of a dividend (sec. 356(a)(2)). In determining whether an exchange has the effect of a dividend, the principles that apply for purposes of distinguishing redemptions from ordinary distributions are applied.[123] Thus, an inquiry is made as to whether the exchange effected a meaningful reduction in the shareholder's interest.[124]

Unlike the rules that apply to ordinary dividends, under the boot dividend rules, a shareholder's dividend income is limited to his ratable share of accumulated earnings and profits; current earnings and profits are not taken into account. If the amount of gain exceeds the allocable portion of earnings and profits, the excess is generally treated as capital gain.

Because the taxation of boot as a dividend is limited to an exchanging shareholder's gain, a shareholder may be able to withdraw corporate earnings at capital gain rates if the distribution occurs as part of a reorganization, even though the amount would be fully taxable as a dividend if distributed apart from a reorganization. This result is inconsistent with the theory that tax-free treatment is appropriate because the transaction is a continuation by the shareholder of his interest in the same corporate enterprise.

Possible Proposal

Consideration could be given to repealing the rule that treats boot as a dividend only to the extent of gain. The Advisory Group on Subchapter C included this proposal in its 1958 report to the House Committee on Ways and Means.[125] Further, the rule that limits the amount of a boot dividend to the ratable share of accumulated earnings and profits could be repealed.[126] These proposals would have the effect of coordinating the rules for distributions occurring as part of a reorganization with those applicable to ordinary distributions.

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[123] *See* Rev. Rul. 84-114, 1984-2 C.B. 90.

[124] There is conflicting authority regarding whether dividend equivalency should be tested by looking at a hypothetical redemption of the exchanging shareholder's interest in the acquired corporation or the acquiring corporation. *Compare Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978) *and* Rev. Rul. 75-83, 1975-1 C.B. 112 *with Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973). For a discussion of whether both approaches have application in particular circumstances, see Kyser, The Long and Winding Road: Characterization of Boot under Section 356(a)(2), 39 Tax L. Rev. 297 (1984).

[125] Hearing before the House Committee on Ways and Means, 86th Cong. (1959) *Revised Report on Corporate Distributions and Adjustments*, prepared by the Advisory Group on Subchapter C.

2. Treatment of Securities as Boot

Present Law and Background

A shareholder or security holder is treated as receiving boot if the principal amount of securities received in a reorganization exceeds the principal amount of securities surrendered, or if securities are received and no securities are surrendered (sec. 354(a)(2)). In such a case, the amount of boot is the fair market value of the excess principal amount, or the fair market value of the principal amount if no securities are surrendered (sec. 356(d)).

Because the applicable statutory provision focuses on "principal amounts," but does not take the time value of money into account, the measurement of boot is distorted. For example, no amount is treated as boot as long as there is no differential between the principal amount of the security received and that of the security surrendered, even if the value of the new security exceeds the adjusted basis of the old security.

Possible Proposal

The amount of nonqualifying consideration received by an exchanging security holder could be measured by the difference between the adjusted issue price of securities surrendered and the issue price of securities received. The term "issue price" would be defined as in sections 1273 and 1274 (relating to the calculation of original issue discount). "Adjusted issue price" would be defined as in section 1275(a)(4)(B)(ii)(I).

Conforming amendments would be made to section 355, relating to the distribution of stock or securities of controlled corporations.

3. Treatment of Acquired Corporation's Debts

Present Law and Background

In general, no gain or loss is recognized by a corporation that exchanges property, pursuant to a plan of reorganization, solely for stock or securities of the acquiring corporation (sec. 361(a)). In addition, the transferor corporation recognizes no gain or loss on account of the receipt of boot, provided the corporation distributes the boot in pursuance of the plan of reorganization (sec. 361(b)). If a reorganization takes the form of one corporation transferring its assets to another corporation, the transferor corporation generally is required to completely liquidate. Because the transferor corporation goes out of existence, the parties to the reorganization must provide a mechanism for settling the corporation's debts. The tax consequences to the transferor corporation turn on the form, not the substance, of the transaction by which the corporation is relieved of its liabilities.

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[126] This modification would also be appropriate as a conforming amendment should the proposal to eliminate the earnings-and-profits concept be adopted.

Under present law, the following procedures may be followed without the transferor corporation being treated as receiving boot, or otherwise recognizing gain:

(1) The acquiring corporation may assume the transferor corporation's liabilities, unless a principal purpose of the assumption or acquisition is tax avoidance (sec. 357). In such a case, the transferor corporation would receive qualified consideration with a value equal to that of the transferred assets, net of the liabilities assumed;

(2) the shareholders of the transferor corporation may assume its liabilities (in which case, the corporation would be viewed as having received a tax-free contribution to capital); or

(3) the transferor corporation may retain enough cash (or other liquid assets) to satisfy its liabilities.

In any case, the parties to the reorganization would end up in the same posture: the transferor corporation would be relieved of its liabilities, and the consideration ultimately received by its shareholders would be reduced by the amount of such liabilities. On the other hand, as described below, the use of other procedures that have the same economic effect may result in the recognition of income by the transferor corporation.

If the transferor corporation distributes boot to creditors rather than stockholders, the transfer would not be considered as made in pursuance of the plan of reorganization.[127] Thus, the transferor corporation would be taxed on receipt of the boot. In addition, the Internal Revenue Service views the transfer of qualified consideration to a creditor as a taxable exchange, resulting in the realization of gain or loss by the transferor corporation.[128] These tax consequences occur even though the parties to the reorganization may have been able to achieve the same economic results by utilizing one of the procedures described in the preceding paragraph.

One other possibility for nonrecognition treatment is provided by the statutory provision that governs the treatment of a corporation that liquidates within twelve months of adopting a plan of complete liquidation, described in Part III., above (sec. 337). If section 337 applies, the transferor corporation would recognize no gain or loss on a deemed sale to a creditor within the twelve-month liquidation period. This nonrecognition provision may be unavailable because there is conflicting case law regarding whether the liquidation provisions and the reorganization provisions are mutually exclusive.[129] In this connection, many tax practitioners assume that section 336, which is also a liquidation provision, provides nonrecognition treatment to a corporation that distributes qualified consideration pursuant to a plan of reorganization.[130] If so, it would appear that the application of section 337 should not be objected to on the grounds that the liquidation provisions cannot apply if the reorganization rules apply.

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[127] *Minnesota Tea Company* v. *Helvering*, 302 U.S. 609 (1938).

[128] Rev. Rul. 70-271, 1970-1 C.B. 166 (situation 1).

[129] *See, FEC Liquidating Corporation* v. *United States*, 548 F.2d 924 (Ct. Cl. 1977) (the application of which would deny nonrecognition treatment under section 337 on a "deemed sale" of stock to a creditor); and, *General Housewares Corporation* v. *United States*, 615 F.2d 1056 (5th Cir. 1980) (holding that section 337 applied where the acquired corporation sold part of the stock received as consideration for its assets in a reorganization and used the sale proceeds to pay debts).

[130] *See, e.g.*, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, 14-103 n. 274 (4th ed. 1979).

Possible Proposal

Section 361 could be amended to prevent the recognition of gain by an acquired corporation that uses qualified consideration or boot to pay off debts. In addition, present law could be clarified to expressly provide nonrecognition treatment to a corporation that disposes of consideration received pursuant to a plan of reorganization; in such a case, the application of sections 336 and 337 would be proscribed. If this proposal were adopted, the taxation of corporations that are acquired in reorganizations would no longer turn on the form in which the corporation's debts are settled.

4. Treatment of Acquiring Corporations in Triangular Reorganizations

Present Law and Background

Section 1032 provides nonrecognition treatment for a corporation that acquires property in exchange for its stock. In a triangular reorganization, a principal part of the consideration used by the acquiring corporation consists of stock of its parent corporation. Although the Internal Revenue Service has ruled that nonrecognition treatment is available to a corporation that uses its parent's stock as consideration in a transaction that qualifies as a reorganization,[131] the statutory support for such treatment is unclear.

Possible Proposal

Section 1032 could be amended to provide explicitly that no gain or loss is recognized on the transfer of parent-corporation stock pursuant to a plan of reorganization.

5. Boot Derived from Reorganizations Involving Certain Foreign Corporations

Present Law and Background

Under section 1248, gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. person owning ten percent or more of the voting stock could be treated as a dividend. This rule was designed to prevent U.S. taxpayers from accumulating earnings free of U.S. tax in a controlled foreign corporation, and then (rather than repatriating the earnings in the form of dividends that would not be eligible for the dividends received deduction) disposing of the stock at capital gains rates for a price that reflects the accumulated earnings.

In general, section 1248(g) provides exceptions for cases in which realized gain is taxable as ordinary income under other provisions of the Code. In the case of gain realized in connection with a reorganization, however, the statutory exception refers to "any gain realized on exchanges to which section 356 . . . applies" (sec. 1248(g)(2)). Thus, under a literal interpretation of the statute, section 1248 is inapplicable to a shareholder who receives boot pursuant to a plan of reorganization, even if the boot is taxed as capital gain.

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[131] Rev. Rul. 57-278, 1957-1 C.B. 124 (without discussion of the basis for this conclusion). *See also* Prop. Treas. Reg. sec. 1.1032.2 (which would interpret section 1032 as reaching the desired result).

Possible Proposal

The scope of section 1248(g)(2) could be limited to that of the other exceptions contained in section 1248(g). That is, the general rule should not apply to the extent that section 356 operates to characterize a shareholder's gain as dividend income, but would apply if the gain is taxed as capital gain.

6. Transfer of Property to Controlled Corporations

Present Law and Background

No gain or loss is recognized by a taxpayer who transfers property to an 80-percent controlled corporation solely in exchange for stock or securities in the corporation (sec. 351). Gain, but not loss, is recognized to the extent that the consideration for the transfer consists of property other than qualified consideration. The transferee's basis in the property is the same as the basis in the hands of the transferor, increased by the amount of gain (if any) recognized by the transferor (sec. 362). The transferor's basis in the stock or securities received is equal to the basis in the property transferred, increased by the amount of gain recognized and decreased by the amount of boot received (sec. 358).

Possible Proposals

In its report proposing the Subchapter C Revision Act of 1985,[13a] the staff of the Senate Finance Committee identified the following problem areas under section 351: (1) Although there is an overlap between section 351 and reorganization provisions, the limitations on the receipt of securities in a reorganization do not apply to a section 351 exchange; and (2) where the property transferred has a basis that exceeds its fair market value, taxpayers can duplicate corporate level losses.

Under the Senate Finance Committee staff proposal, the same nonrecognition rule that applies to securities received in a reorganization would apply to securities received in a section 351 exchange. Thus, securities would not be received tax-free if no securities were surrendered. Further, if the basis of the property transferred exceeded fair market value at the time of the exchange, then the transferor's basis in the qualified consideration received would equal the fair market value of the transferred property (increased by the amount of recognized gain and decreased by the amount of boot).

[13a] Staff of the Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985* (S. Prt. 99-47), May, 1985.

C. Miscellaneous Provisions

1. Depreciation Recapture in Certain Tax-Free Exchanges

Present Law and Background

The recapture rules prevent the conversion of ordinary income to capital gains by requiring gain on the disposition of depreciable property to be taxed as ordinary income (rather than capital gains), to the extent of depreciation deductions taken with respect to the property. Under present law, a taxpayer can effectively assign ordinary recapture income to another taxpayer by transferring depreciable property in a tax-free exchange. For example, section 1245(b) provides an exception to the recapture rule for depreciable personal property where the property is transferred to a controlled corporation in a transaction accorded nonrecognition treatment under section 351. Similarly, an acquired corporation recognizes no recapture income if it transfers depreciable assets in a tax-free reorganization. If depreciable property is transferred to a corporation that has net operating losses, for example, no tax may be imposed on the recapture income.

Possible Proposal

Consideration could be given to applying the depreciation recapture rules whenever an asset is no longer accounted for on the return that benefitted from the previously-claimed deductions. Thus, there would be recapture in all otherwise tax-free acquisitive reorganizations, as well as when a subsidiary is no longer included in the consolidated return of the affiliated group that claimed the deductions.[132]

Alternatively, some other mechanism could be devised to prevent the assignment of recapture income. For example, in a section 351 exchange, the shareholder's stock might be tainted so that ordinary income would result on disposition of the stock (or of the asset), to the extent of recapture income at the time of the section 351 transfer. In such a case, there would be a corresponding adjustment to the asset's basis in the hands of the corporation when the shareholder is taxed.

2. Conversion of a C Corporation to an S Corporation

Present Law and Background

In general, an S corporation is not subject to tax but is treated as a conduit, similar to the treatment of partnerships. Thus, shareholders who elect to treat their existing closely held corporation as an S corporation effect a material change in the tax character of their investment. Nevertheless, the conversion of a C corporation to an S corporation is not a taxable event.

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[132] Similarly, the Administration's proposal to impose a recapture tax on excess depreciation would prevent taxpayers from circumventing the proposed recapture rule by transferring property in nonrecognition transactions. This proposal is discussed in Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Capital Income* (JCS-35-85), August 8, 1985.

Possible Proposal

An election to convert C corporations to S corporations, or certain acquisitions by S corporations of C corporations, could be treated as taxable events, at least with respect to recapture income.

3. Worthless Stock Deductions

Present Law and Background

Under section 165(g), taxpayers can deduct losses resulting from the worthlessness of corporate securities. Generally, such losses are capital losses. However, if a parent corporation owns at least 80 percent of each class of a subsidiary's stock and the subsidiary has derived more than 90 percent of its gross receipts from active business activities, the loss to the parent from worthlessness of the subsidiary's stock is an ordinary (rather than capital) loss. Whether stock is worthless is determined on the basis of facts and circumstances, some of which may be subject to the control of the parent.[133] The provision may be intended to prevent certain disparities in treatment between a branch and a subsidiary. However, it has been suggested that in some circumstances the availability of ordinary loss treatment may encourage a parent corporation to claim and cause worthlessness of a subsidiary rather than continue operations when the subsidiary stock has declined in value.

A separate issue may arise in the case of a non-consolidated subsidiary that is believed worthless in one year but is later revived by infusion of new assets. In *Textron, Inc.* v. *United States*, 561 F.2d 1023 (1st Cir. 1977) the court held that, even though the taxpayers had claimed an ordinary worthless stock deduction, the net operating losses of the subsidiary could still be used to shelter income from the new business.

Possible Proposals

Some argue that it would be desirable to eliminate the disparity between claiming worthlessness and otherwise disposing of subsidiary stock by requiring capital loss treatment in all cases.

With respect to the *Textron* issue, some have suggested a rule that whenever a corporation's stock becomes worthless, (or at least when this has produced an ordinary loss deduction), its preexisting tax attributes (such as net operating losses and credit carryovers) should be extinguished.

4. Taxes of a Shareholder Paid by the Corporation

Present Law and Background

If a corporation pays a tax imposed on a shareholder on an interest as a shareholder, present law allows a deduction to the corporation rather than the shareholder whose tax is paid (sec. 164(e)).

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[133] Facts that may be considered relevant and that may be subject to the parent corporation's control include the following: when the subsidiary is liquidated, when it terminates operations, when the parent ceases to advance operating capital, and when its operating officers abandon any hope or expectation of realizing a profit.

This rule is inconsistent with the general rule that taxes are deductible only by the person on whom they are imposed. The provision was originally adopted to provide a deduction to banks that voluntarily paid local taxes imposed on their shareholders, but operates to permit corporations to pay a deductible dividend. *See Hillsboro National Bank* v. *Commissioner*, 457 U.S. 1103 (1983). The extent to which the provision is in current use is unclear.

Possible Proposal

Section 164(e) could be repealed. If section 164(e) is repealed, a corporation's payment of a tax imposed on a shareholder would be treated as a taxable dividend to the shareholder.

5. Deferral by Solvent Taxpayers of Discharge of Indebtedness Income

Present Law and Background

In general

Code section 61(a)(12) provides that gross income includes "income from discharge of indebtedness." While in general the statute does not further define that term, discharge of indebtedness is generally considered to occur when a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt. For example, if a corporation has issued a $1,000 bond at par which it later repurchases for only $900 (thereby increasing its net worth by $100), the corporation realizes $100 of income in the year of repurchase.[134]

Pursuant to certain statutory exceptions (sec. 108), income is not currently recognized from discharges arising in a title 11 (bankruptcy) case, or from discharges outside of bankruptcy to the extent the taxpayer is insolvent before the discharge.[135] Although income is not recognized currently in these bankruptcy or insolvency cases, certain tax attributes of the debtor—including net operating loss carryovers, certain credit carryovers, and the basis of assets—must be reduced, in a specified order, by the amount of the discharged debt, unless the taxpayer elects first to reduce the basis of depreciable property by the debt discharge amount. If the debt discharge amount exceeds the amount of tax attributes that can be reduced, it has no tax consequence.

In the case of a solvent debtor outside bankruptcy, the full amount of discharged debt generally is recognized as income in the year the discharge occurs. However, a solvent taxpayer may elect to adjust the basis in its depreciable assets (or realty held as inventory) in place of currently recognizing income (secs. 108(c) and 1017), thereby deferring recognition for tax purposes. This election is available for discharge of any indebtedness incurred by a corporation, or indebtedness of an individual incurred in connection with the individual's trade or business (sec. 108(d)(4)).

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[134] *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931); *Helvering* v. *American Chicle Co.*, 291 U.S. 426 (1934); *Comm'r* v. *Jacobson*, 336 U.S. 28 (1949); Treas. Reg. sec. 1.61-12(a).

[135] If a taxpayer is insolvent before the discharge occurs, the amount of the taxpayer's insolvency must be determined. If the amount of the discharge exceeds the amount of the taxpayer's insolvency, the excess must be currently recognized as income unless excepted under some other provision.

For an electing solvent taxpayer, the adjustment is made by reducing the basis, but not below zero, of depreciable assets held at the beginning of the taxable year following the year in which the discharge of indebtedness occurs (sec. 1017(a)). If the debt discharge amount exceeds the amount of basis in depreciable property, the excess is not eligible for the election and must be currently recognized as income.

Reduction of basis under this election is subject to recapture as ordinary income on sale of the property whose basis was reduced (sec. 1017(d)). However, reduction of basis does not constitute a disposition of property for any tax purpose, including recapture of the investment tax credit (sec. 1017(c)(2)).

A provision allowing solvent debtors to reduce the basis of assets rather than recognize immediate income on a discharge of business debt has been in effect since 1939. The original provision was limited to solvent corporate taxpayers in "unsound financial condition." The financial condition limitation was later dropped due to administrative difficulties in identifying such taxpayers.[136] The 1954 Code extended the election to individuals (if the debt had been incurred in connection with property used in the taxpayer's trade or business). The Bankruptcy Tax Act of 1980 modified the rule further so that a solvent debtor, to avoid current taxation, must reduce basis in depreciable assets.

In the case of a solvent debtor outside bankruptcy, present law also provides that if a seller of specific property reduces the debt of the purchaser that arose out of the purchase, the reduction to the purchaser of the purchase money debt is treated (for both the seller and the buyer) as a purchase-price adjustment on that property. This provision was enacted to eliminate disputes between the Internal Revenue Service and the debtor as to whether in a particular case the debt reduction should be treated as discharge of indebtedness income or a true price adjustment.[137] If the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), this provision does not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment. Also, this provision does not apply where the debt is reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation.

Internal Revenue Service study of basis adjustment by solvent corporations

In 1980, the Treasury Department reported on an Internal Revenue Service study on the ability of solvent corporations (outside bankruptcy) to avoid recognizing current income from discharge of indebtedness by reducing asset basis.[138] (Under the law in effect at the time of the study the debtor could reduce basis in nondepreciable assets that might never be sold, thereby completely avoiding—rather than deferring—the tax consequences of debt discharge.) The study examined approximately 215,000 corporate returns filed during a six-month period during 1979, 65 of which had made use of the election.

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[136] S. Rep. No. 1631, 77th Cong., 2d Sess. 46 (1942).

[137] See H. Rpt. No. 96-83, 96th Cong., 2nd Sess. (1980); S. Rpt. No. 96-1035, 96th Cong., 2nd Sess. (1980).

According to the study, the basis-reduction election was "apparently used disproportionately by the very largest corporations." Thus, more than half of the electing corporations had assets in excess of $250 million, although such corporations made up only one-tenth of one percent of all corporations at that time. Also, only three of the 65 had assets of less than $1 million, despite the fact that such corporations constituted 91 percent of all corporations at that time. In addition, the study found that only 25 percent of the electing corporations had reported a tax loss in any of the four most recent taxable years and that only 11 percent had reported a tax loss in more than one of the four most recent taxable years.

Possible Proposals

It has been suggested that present law may provide an inappropriate tax deferral to those solvent taxpayers (outside bankruptcy) who elect to reduce the basis of depreciable assets and thereby avoid currently recognizing income from a discharge of qualified business indebtedness. It is pointed out that even if some deferral were viewed as appropriate, the particular deferral resulting from reduction of basis in depreciable property may not produce an effect consistent with any particular policy goal.

Under one possible proposal, the present-law rules could be modified either to require the current inclusion in income of the full debt discharge amount, or to provide a method of deferral that matches the discharge of indebtedness income against any additional costs incurred to obtain the discharge. If it is deemed desirable to permit additional deferral in the case of a taxpayer that is financially troubled (but not insolvent or bankrupt) at the time of business debt discharge, consideration could be given to treating such "workout" situations separately from refinancings occasioned by more general changes in interest rates, and to adopting a more evenhanded method of determining the deferral period, such as permitting deferral over a specified time period.

Analysis

Overview

The election granted a solvent taxpayer to reduce the basis of depreciable assets rather than recognize current income in the discharge of business indebtedness evolved out of a provision originally intended to assist financially troubled taxpayers for whom immediate income recognition could be a hardship.

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[138] *Written Comments on Certain Aspects of H.R. 5043; Bankruptcy Tax Act of 1979*, Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 96th Cong., 2nd Sess. (February 20, 1980) (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury).

The Internal Revenue Service study (referred to above) indicated that most corporate use of basis-adjustment deferral (as reflected on returns filed over a six-month period in 1979) was by large, profitable corporations. This suggests that repurchase of debt whose value had declined due to a general rise of interest rates may have played a significant role in obtaining discharges of indebtedness by these corporations.

Proponents of a change in present law contend that the substantial carryover period now allowed for net operating losses (generally, 15 years) may provide adequate relief to taxpayers that obtain discharges of business debt in the context of financial difficulties and that allowing solvent taxpayers to reduce the basis of depreciable assets instead of recognizing current income permits inappropriate deferral. Thus, they question whether any deferral is desirable.

Some may argue that even given the present law net operating loss carryover rules, it might still be desirable to provide relief to financially troubled taxpayers. Since identifying these taxpayers has proven administratively difficult in the past, they may urge retention of present law, even though it permits deferral that varies based on the taxpayer's depreciable assets. Another approach would be to permit deferral in hardship cases over a specified time period (*cf.* sec. 6161(b)).

Another approach would be to permit an offset to income, or a deferral, only to the extent additional expenses of refinancing are incurred and can be demonstrated.

Additional expense example; repurchase of debt

Where discharge income arises as a result of the repurchase of the taxpayer's own debt, additional expenses may be incurred in order to obtain the discharge based on the source of the funds used to repurchase the debt. If only internally generated funds are used, no additional charges may be incurred other than the transaction costs associated with the repurchase. In this case, there is no future stream of expenses against which to offset the income from discharge. Accordingly, unless deferral is desired for some other reason such as relief to a financially troubled taxpayer, the appropriate time for recognition of discharge income should be the taxable year in which the repurchase occurs.

If the money needed to repurchase the debt is borrowed, it is likely that additional expenses will be incurred in the form of additional interest payments. Generally, the debt will not be available for repurchase at a discount from its principal amount unless the interest at which that debt was originally issued is now less than the rate the market will demand for current borrowing from the taxpayer. Whether this change represents a general movement in interest rates, or a change in the credit worthiness of the taxpayer, the result should be the same. In order to borrow the funds to repurchase the debt, a higher interest rate must be paid.

The following example shows two roughly equivalent notes with their discounted present values at 12.68 percent interest per year. The first note was issued for $100,000 when interest rates were 10 percent and can now be repurchased for $90,492. In order to effect the repurchase, a new note for $90,492 paying market interest will have to be issued.

Year	Old Note		New note	
	Nominal value	Present value	Nominal value	Present value
1	$10,000 (i)	$8,875	$11,475 (i)	$10,185
2	10,000 (i)	7,876	11,475 (i)	9,039
3	10,000 (i)	6,989	11,475 (i)	8,020
4	10,000 (i)	6,202	11,475 (i)	7,119
5	10,000 (i)	5,505	11,475 (i)	6,318
5	100,000 (P)	55,045	90,492 (P)	49,811
Total		90,492		90,492

The numbers used in the example reflect rounding for presentation purposes.

I=interest; P=principal.

In this case, there is discharge of indebtedness of $9,508, the difference between the principal amount of the original note and the price at which it is repurchased. However, the taxpayer must pay a cost to obtain the discharge in the form of an additional $1,475 per year of interest for five years, or a total of $7,375.

In order properly to match income with the expenses incurred to produce such income, at least $7,375 of the $9,508 discharge income should be offset against the additional interest expense. The remaining $2,133 could also be matched against the additional interest or could be required to be recognized immediately.

In some situations, it may be difficult to tell exactly which new debt is replacing what repurchased debt, or to determine against which stream of interest payments the discharge income should be matched. Since the deferral provides a benefit to taxpayers as compared with immediate recognition, the taxpayer could be required to show clearly which new debt is the replacement debt. This could be done by requiring replacement debt to be designated as such at the time of its creation, and by requiring a tracing of the proceeds of the replacement debt to the transactions resulting in the discharge of indebtedness. Some might contend that any permitted tracing should be limited to fairly obvious refinancing cases, in light of the general administrative difficulty of tracing borrowed funds.

The repurchase of debt example is only one area in which additional expenses may be incurred in order to obtain discharge of indebtedness income. If such expenses are incurred in other types of discharges of qualified business indebtedness, and matching is desired, a similar approach could be used.

6. Basis in Stock of Controlled Subsidiary

Present Law and Background

Although the acquisition of a corporation's stock and the acquisition of its assets often have identical economic consequences, the tax consequences of the two transactions may vary. One discontinuity that results relates to the difference between an acquiring corporation's basis for stock in the acquired corporation ("outside basis") and the acquired corporation's asset basis ("inside basis"). For example, if an acquiring corporation acquires stock, the acquired corporation's basis for its assets would be unaffected (unless a section 338 election is made to treat the stock acquisition as an asset acquisition). In such a case, the acquiring corporation's outside basis may have no relation to the inside basis. In contrast, if the acquiring corporation purchases assets and contributes the assets to a newly formed subsidiary corporation (or is treated as having purchased assets under section 338), the inside and outside bases would be comparable. Further, unless the acquired corporation is included in the acquiring corporation's consolidated Federal income tax return, the acquired corporation's earnings would not increase the outside basis (although the inside basis would be increased by subsequent earnings).

Possible Proposal

In its proposed Subchapter C Revision Act of 1985,[139] the staff of the Senate Finance Committee suggests a rule that would conform the outside basis of a controlling corporate shareholder to the inside basis. This rule is thought to be necessary because present law permits taxpayers to claim double gains or double losses where there is a disparity between inside and outside basis (similar to the problem discussed in Part V.B.6., above, relating to section 351 exchanges). Further, there is a concern about discontinuities between the treatment of stock acquisitions and asset acquisitions.

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[139] See n. 131a, *supra.*

OPENING STATEMENT OF SENATOR DOLE, HEARING ON SUBCHAPTER C

Mr. Chairman, you have brougnt to the committee a very distinguished group of witnesses to comment on the staff recommendations to improve the corporate tax provisions of the Internal Revenue Code. Subchapter C of the Code is not known for its simplicity or its coherence. I hope these hearings may be an important step in reform. With the Ways and Means Committee beginning its tax reform markup and our committee's efforts not far ahead, this hearing is certainly timely.

I think it may be useful to describe some of the background behind the staff project. In 1982, while I was chairman, we included as part of the Tax Equity and Fiscal Responsibility Act a few fundamental modifications of the corporate tax rules, and closed certain corporate tax loopholes. One of the more significant changes was a provision involving liquidations suggested by Senator Danforth. During consideration of those changes, a number of groups criticized the committee for moving too quickly. I can recall the ABA representative urging us to slow down, take two years to study subchapter C, consult with them, and reform the rules correctly. Later that year, I asked the committee staff to do precisely that, and to report their suggestions to the committee.

Well, the staff has taken more than two years to study the subject, and has consulted with representatives of the ABA and a number of other professional organizations and individuals on a regular basis. Where we had consensus, we added several proposals to the Deficit Reduction Act of 1984. Other issues deserved, and received, additional analysis. I know that a distinguished representative of the ABA is here today to express his group's views on this project, and I will be particularly interested in hearing his views on the process culminating in the final staff report.

There are those here who will urge the committee to study this area further. Now, we are not adverse to studying a subject carefully, and we try not to act precipitously when we enact legislation. But it seems to me, at some point, we have to differentiate between those who really believe more study is necessary, and those who just don't like the proposals.

As it is, this is probably the slowest moving, most-studied tax legislative project we have had in some time. Some proposals barely get one hearing; this proposal will have had at least two. Some proposals often are not presented to the public in the form of legislative language; in this one, such language has already been drafted and published. Some proposals offer minimal explanatory background material; this proposal cannot be faulted on that ground. Some proposals are enacted very quickly; this proposal has already had almost three years of study, and is based largely on an American law Institute study spanning eight years before that.

Now, I have an open mind as to whether we should move ahead with this. But at some point, we must make a decision, we cannot just study a project to death. We must decide whether this is an improvement over current law. If it is, then perhaps it is time to move ahead with it. If it is not, then perhaps we should drop it altogether and move ahead without it.

Two final comments. First I'm sorry that we could not accommodate everyone who requested to testify at this hearing. I understand that there was a long list of requests and because of time constraints, we could not include everyone. I would encourage those who requested to appear and who did not make the witness list to submit written testimony to the committee. It will be reviewed as carefully as the testimony of those appearing here today.

Second, I would like to publicly thank the following tax practitioners and academicians who contributed much time and effort to this project. They are Bernard Aidinoff of New York City; Donald Alexander of Washington, D.C.; William Andrews of Cambridge, Massachusetts; Frank Battle of Chicago; Herbert Camp of New York City; Jerold Cohen from Atlanta; James Eustice of New York City; Peter Faber of New York City; Martin Ginsburg of Washington, D.C.; Fred Goldberg of Washington, D.C.; Harold Handler of New York City; James Holden of Washington, D.C.; Robert Kacobs of New York City; Howard Krane of Chicago; Robert Lawrence of New York City; Richard May of Washington, D.C.; Willard Taylor of New York City; and Mark Yecies of Washington, D.C.

In addition, I would like to thank Jim Dring, Jack Sterling, Paul Jacokes, Harold Hirsch, and Labrenda Stodghill of the Joint Committee Staff; Rick D'Avino and Eric Elfman of the Treasury staff; Jerry Mason and Marc Blumkin from the IRS; Jim Fransen from Legislative Counsel's Office; and Bill Wilkins, Andre Le Duc, and George Yin of our staff, who all helped in putting this project together.

I can't think of a more outstanding group of tax professionals to assist on a project of this nature, and the committee thanks you.

Senator CHAFEE. Good morning, everybody. Today we are having a hearing on the proposals to revise subchapter C of the Internal Revenue Code. We have Mr. Pearlman followed by four panels.

I have a statement here from Senator Dole which I will read in its entirety, because this really states my views as well:

"You have brought to the committee a very distinguished group of witnesses to comment on the staff recommendations to improve the corporate tax provisions of the Internal Revenue Code. Subchapter C of the code is not known for its simplicity or its coherence. I hope these hearings may be an important step in reform. With the Ways and Means Committee beginning its tax reform markup and our committee's efforts not far ahead, this hearing is certainly timely.

"I think it may be useful to describe some of the background behind the staff project. In 1982, while I was chairman, we included as part of the Tax Equity and Fiscal Responsibility Act"—so-called "TEFRA"—"a few fundamental modifications of the corporate tax rules, and closed certain corporate tax loopholes. One of the more significant changes was a provision involving liquidations suggested by Senator Danforth. During consideration of those changes, a number of groups criticized the committee for moving too quickly. I can recall the ABA representative urging us to slow down, take 2 years to study subchapter C, consult with them, and reform the rules correctly. Later that year, I asked the committee staff to do precisely that, and to report their suggestions to the committee.

"Well, the staff has taken more than 2 years to study the subject, and has consulted with representatives of the ABA and a number of other professional organizations and individuals on a regular basis. Where we had consensus, we added several proposals to the Deficit Reduction Act of 1984. Other issues deserved, and received, additional analysis. I know that a distinguished representative of the ABA is here today to express his group's views on this project, and I will be particularly interested in hearing his views on the process culminating in the final staff revort.

"There are those here who will urge the committee to study this area further. Now, we are not adverse to studying a subject carefully, and we try not to act precipitously when we enact legislation. But it seems to me, at some point, we have to differentiate between those who really believe more study is necessary, and those who just don't like the proposals.

"As it is, this is probably the slowest moving, most-studied tax legislative project we have had in some time. Some proposals barely get one hearing; this proposal will have had at least two. Some proposals often are not presented to the public in the form of legislative language; in this one, such language has already been drafted and published. Some proposals offer minimal explanatory background material; this proposal cannot be faulted on that ground. Some proposals are enacted very quickly; this proposal has already had almost 3 years of study, and is based largely on an American Law Institute study spanning eight years before that.

"Now, I have an open mind as to whether we should move ahead with this. But at some point, we must make a decision, we cannot just study a project to death. We must decide whether this is an improvement over current law. If it is, then perhaps it is time to move ahead with it. If it is not, then perhaps we should drop it altogether and move ahead without it.

"Two final comments. First, I'm sorry that we could not accommodate everyone who requested to testify at this hearing." And I must say, when you look at the list, we have done pretty well. We are going to be here a while.

"Those who requested to appear and who could not be on the witness list are urged to submit their written testimony to the committee," where it will be studied carefully, as well as the testimony of those who appear here.

Let me say this to start with: Everybody's testimony will be part of the record today, so you don't have to ask; that is automatic.

"Second, I would like to publicly thank the following tax practitioners and academicians who contributed much time and effort to this project," and that is the study group that put this green book together. "They are Bernard Aidinoff of New York City; Donald Alexander of Washington, DC.; William Andrews of Cambridge, MA; Frank Battle of Chicago; Herbert Camp of New York City; Jerold Cohen from Atlanta; James Eustice of New York City; Peter Faber of New York City; Martin Ginsburg of Washington; Fred Goldberg of Washington; Harold Handler of New York City; James Holden of Washington; Robert Jacobs of New York City; Howard Krane of Chicago; Robert Lawrence of New York City; Richard May of Washington; Willard Taylor of New York, and Mark Yecies of Washington."

It looks like Washington and New York kind of had a grip on this thing, doesn't it? How did those fellows from Atlanta and Chicago sneak in here? Well, we're broadbased. [Laughter.]

Senator **Chafee**. "In addition, I would like to thank Jim Dring, Jack Sterling, Paul Kacokes, Harold Hirsch, and Labrenda Stodghill of the Joint Committee staff; Rick D'Avino and Eric Elfman of the Treasury staff; Jerry Mason and Marc Blumkin from the IRS; Jim Fransen from legislative counsel's office; and Bill Wilkins, Andre Le Duc, and George Yin of our staff, who all helped in putting this project together.

"I can't think of a more outstanding group of tax professionals to assist on this project," and the committee thanks each and every one of you for helping out.

So, let's move ahead now with Mr. Pearlman, Assistant Secretary of the Treasury.

We welcome you here, Mr. Pearlman. Please go ahead.

STATEMENT OF HON. RONALD A. PEARLMAN, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. **Pearlman**. Thank you, Mr. Chairman. Good morning.

This is our second opportunity to appear before the committee on the subject of the basic reform of the taxation of corporations and shareholders. We first appeared back in October 1983 before the full committee to comment on the preliminary staff report, and we are pleased to be here this morning to testify in connection with the subcommittee's hearings on the final staff report.

Let me begin by expressing, as we did previously, our support for the committee's efforts to undertake a serious review and reform of subchapter C. I think the work of the working group and of the Finance Committee staff and others who have been involved in this process over the last several years, in connection with both the preliminary and final reports, has simply been outstanding. It has contributed significantly to the reform process, and our hats at Treasury are off to all of those who have participated.

Senator **Chafee**. Now drop the other shoe. [Laughter.]

Mr. **Pearlman**. Our reactions to the final report, as you implied by your comment, are mixed. My main focus this morning is going to be on the net operating loss carryover rules, but let me briefly comment on the remainder of the other proposals, principally those relating to acquisitive reorganizations and purchase transactions and related transactions.

First, we think extensive changes in subchapter C simply cannot be viewed in a vacuum, and I know the committee and I think the staff shares that view, but must be viewed in light of substantial legislative activity over the past several years and the prospect of significant additional legislative activity in connection with fundamental tax reform.

The relative importance of changes to subchapter C versus other tax legislative changes obviously is going to be the subject of legitimate debate. Our view is that broad changes in subchapter C are not essential to the fundamental tax reform project and should follow the Congress's review of fundamental tax reform rather than precede it.

We continue to be concerned, as we have expressed over the last couple of years, with the potential economic effects of the broad changes to the acquisitive reorganization provisions. I don't mean to say that in any negative way. I don't mean to presuppose what those economic effects are, but simply that we think there is a potential for very significant economic effects on merger and acquisition activity in this country, and that it is essential for this subcommittee and for the Finance Committee to take those effects into consideration.

I think the step the subcommittee is taking this morning, of including for the first time in the deliberation, as I am told, some input from two distinguished economists, will aid significantly in evaluating those economic effects. But I think this is an area where we should be very careful that we, as technicians, not let our interest in making sure that the statute is improved, made more workable, and all the other wonderful things we can do with it, not also be impacted and influenced significantly by careful and deliberate economic analysis.

What I would like to do in the short time that we have this morning is turn to the portion of the staff report dealing with the carryover of net operating losses and other tax attributes.

Mr. Chairman, because we have submitted a rather lengthy written statement on this subject, I am not going to do anything more than summarize our reactions to the report. I will refer the subcommittee to the written statement for the background, but I would like to take a few minutes to comment on the more salient pieces of the net operating loss proposals.

First, let me say that this is an area where we believe prompt legislative action is important. In 1976, as you are aware, Congress sought to reform the loss-carryover rules. In our judgment, the current law is unsatisfactory, and I think it is fair to say that there is a general consensus that that is the case, although that is not the uniform view.

The 1976 act produced rules that were both complex and controversial. The effective date of those changes has been repeatedly delayed, most recently by the 1984 act, to January 1, 1986.

Because we believe the current law is unsatisfactory and because we believe there has been considerable constructive effort to develop a set of permanent net operating loss rules that are getting very close to the point where they can be considered for enactment, we urge the subcommittee to proceed with the net operating loss aspects of these proposals.

Let me say, in that regard, that we are very strongly supportive of the staff's proposed approach on loss carryovers; we think it can serve as the basis for enacting loss carryover rules. I think it is significant that there seems to be some consensus developing that we are reaching a time when Congress can act on loss carryforwards. Not only do we have a staff report in which we are pleased to come up and say we are in strong support, but the Ways and Means Committee staff recommendations on fundamental tax reform also included essentially the approach recommended by the Finance Committee staff and working group.

Senator **CHAFEE**. Do you mean they dealt with the net operating losses?

Mr. **PEARLMAN**. That is correct.

Senator **CHAFEE**. And that is all?

Mr. **PEARLMAN**. And that is all. That is correct.

Senator **CHAFEE**. And did it do just as the staff report recommended?

Mr. **PEARLMAN**. Well, not "just as." There are some changes, but not dramatic changes. I would say it is fair to say that, essentially, the Ways and Means staff recommendation is the same as the Senate Finance Committee staff report.

Again, because of our ability to try to be as supportive as we can, and an indication that there is interest in some consensus in both the staffs of the Ways and Means and the Finance Committee, I would suggest that this is an issue that is ready to be taken to the membership of the subcommittee, and I would encourage you—because I think it is a very important issue—I would encourage the subcommittee to proceed with that, with at least that aspect of this report.

The staff report has a loss carryover rule, applicable following acquisitions of loss corporations, which seeks to limit the use of net operating loss carryforwards by determining the value of the loss corporation and then trying to determine the assumed future earning stream on that value.

The report adopts a single rule, which is consistent at least with the suggestion that we made in our 1983 testimony. We acknowledge the single rule is not as theoretically precise as the separate rules that apply to mergers and purchase transactions, but we do think it is simpler, more workable, and we prefer that rule, thus we were pleased to see the staff report contain a single rule.

In determining the annual amount of the carryover of net operating losses usable each year, the staff report requires a calculation of a rate of return. The staff report uses the Federal long-term rate that was adopted by the Congress last year in the deferred-sale area. And then it requires that it be applied against the value of the corporation at the time of the substantial change of ownership. Obviously, the determination of the rate of return is very important. The staff selects a market rate that is not, again, a perfect approach; but we think it is a reasonable approach. The staff, as I indicated, uses a long-term adjusted Federal rate. I think we would prefer to use the midterm rate, simply because we think it will more likely than not reflect a midpoint in ranges of rates. There are strong conceptual arguments that can be made that a lower rate should be used; some have suggested that it should be related to the level of absorption of net operating loss, the historical absorption; there also are arguments that a higher rate should be used to reflect the equity of——

Senator CHAFEE. Mr. Pearlman, let me see if I understand this. You would write into the law that it be the Federal long-term rate? You wouldn't put in 12 percent?

Mr. PEARLMAN. No, we would not put in a percentage; I think it has got to be an adjustable rate. I think we would prefer to see the midterm rate used, but we would use an adjustable market rate. I think it is desirable to have a rate that is generally known, that people can look at, and I think that the Federal rates are a fair measure of market rate.

Senator CHAFEE. All right.

Mr. PEARLMAN. So I think, essentially, our only area of disagreement—and it is really not a very strong one; it is quite a mild one—on the basic approach that the staff takes is in terms of what rate you use to determine the rate of return. As I indicated, we would prefer to use the midterm rate, but obviously that is not an earth-shattering issue, and it is one I think should be fairly easy to resolve.

Second, losses are limited to earnings attributable to the value of the loss corporation at the time of change in ownership. This makes the issue of contributions to capital by the historic shareholders a relevant issue. The staff, quite wisely we think, has sought to prohibit intentional increases in value of the corporation prior to an anticipated change of ownership through contributions of capital. And we think that it is important to look at contributions to capital; we think you can't have rule that permits historic shareholders to artificially inflate the value of the corporation in anticipation of a change of ownership.

We think that the staff's suggestion to ignore contributions to capital during a 2-year period prior to a change of ownership is a sensible rule, and the only thing we would suggest is that there are going to be nontransfer motivated needs to infuse capital, such as those infusions of capital that are going to be necessary in the ordinary course of business. We think that exceptions probably will have to be crafted in those instances, and we think that a delegation to Treasury regulation for that purpose is appropriate.

We would be inclined to limit the rule to a 2-year period. The staff report seeks to look at contributions to capital that occur in a longer period of time than 2 years. It is going to be very difficult to police capital contributions over a longer period of time and, in addition, a rule that seeks to do so is going to simply raise greater questions about the definitiveness of the loss carryforward. We think that is undesirable. So, we would be inclined to simply limit the rule to a 2-year period, and capital contributions that occur in an earlier point in time would simply be disregarded for this purpose.

The staff report also contains limits on so-called "investment companies;" that is, companies that have a significant amount of investment assets. In theory, as we have testified before, we think that there should be no limit on the losses carried over by investment companies; that is, there should be no restriction on the ability of a company to liquidate its assets and use its earnings—there are no limits, indeed—to use the earnings from the proceeds of the sale of those assets to offset losses. And we think, conceptually, that should be the case when a loss corporation's ownership changes.

Nevertheless, we recognize the perception problem here. It is a serious perception problem, we think; the staff appropriately recognizes that the ability of a corporation to be sold with nothing in it but very liquid assets and net operating losses will be perceived, we think, by the public as being abusive, and we think it is, therefore, appropriate to try to deal with that issue as the staff has. That is referred to as the so-called investment company rule.

I think we would recommend some changes in that rule that in one sense would soften the staff report, and in a sense would make it a bit more comprehensive. On the one hand, we would soften the rule so that there would be no cliff. The proposal of the staff is that, if the corporation owns investment assets that comprise more than two-thirds of its value, then no net operating losses would be available to be carried over. We would suggest that a cliff is inappropriate, but that the value of the corporation in determining the amount of the loss that is carried forward could be more appropriately reduced by the amount of investment assets so there is no absolute cliff and absolute cutoff of the amount of the net operating losses. On the other hand, that kind of rule would apply also to corporations that have less than two-thirds investment assets.

We would suggest that if the subcommittee were to choose this approach that, instead of using a two-thirds cutoff, we would use a one-third cutoff; that is, that any corporation that has a substantial amount of investment assets—and we would define "substantial" for this purpose as one-third—would at that point begin cutting down its utilization of net operating losses through the calculation of the value of the corporation by the amount of the investment assets.

We would also, incidentally, apply that same rule in the area of built-in gains and losses.

Built-in gains and losses, which is an extremely complicated subject, is a subject that we think is necessary to deal with. In the net operating loss area, there has been a lot of debate as to whether it is necessary or whether it unduly complicates the rules. We think the staff report, in the area of the built-in gains and losses, presents a sound method for dealing with these issues. We particularly applaud the efforts the staff made to make these rules as workable as possible. And I think the effort that is reflected in terms of the netting rule that says you only take built-in gains and losses into the caluculation after you have net the gains and losses, and the de minimus rule, will serve to make the rule more workable. It is not going to be an easy calculation in any event, but we think that it is an area that needs to be dealt with.

We are not comfortable, however, with the extent of the delegation of these rules to Treasury regulation. We think that the statute needs to set out a skeleton of these rules and specifically indicate—we think affirmatively indicate—that built-in deductions should be accounted for in the same manner as recognized built-in losses. I think this is too important an area to leave it solely to a delegation to Treasury regulations. It is going to be tough to articulate further statutory rules. Obviously, we are happy to work with the staff if the subcommittee were disposed to do that.

One of the areas of the carryover provisions that will undoubtedly receive a good deal of comment and is in need of a good deal of consideration, be believe, are the rules that relate to the extent to which loss carryforwards, carryovers, go over in the case of bankruptcy and other insolvency proceedings.

The staff report assures that carryovers of net operating losses in the so-called title 11 bankruptcy proceedings will continue unimpeded. We think it is appropriate that, at least in certain circumstances, creditors of an insolvent corporation be treated as the real equity owners of the corporation, because indeed we think they frequently are. They are the people who have borne the economic loss, particularly if they are the historic creditors.

However, we think that the insolvency rules should apply only to historic creditors. We are much less inclined to think that new creditors who enter the picture shortly before or during a bankruptcy proceeding have suffered that same economic loss as an historic creditor. And so, we would propose to restrict the more generous carryover rules applicable in an insolvency context to historic creditors.

We are also concerned by the limitation of those rules to title 11 proceedings. We think it is not desirable to force people into title 11 proceedings and to discourage informal workouts. We think that is not a constructive economic environment to create.

This is a complicated area, and it is a delicate area, and it is one that simply is going to require additional work. But we think that the staff report does adopt essentially the right policy, and I think it does, in this regard, form the basis for working out a workout insolvency rule that treats workout and insolvency transactions in a neutral and effective way.

The staff proposal imposes no limits on the ability of a loss corporation to acquire a profitable corporation and thereafter utilize the net operating loss. This is just the reverse of the traditional transaction of the profitable corporation going out and acquiring a loss corporation.

In raising this issue, we don't want to impede the ability of loss corporations to rehabilitate themselves through capital contributions from historic shareholders that then are turned into purchases of profitable corporations; and therefore, we think it is appropriate that no restriction be imposed on cash purchases, even if those cash purchases enable the loss corporation to offset the net operating losses by income earned by a profitable acquired corporation. The only qualification we would put on that is that the historic loss corporation shareholders stay in control. Obviously, if there is a substantial change in the ownership of the loss corporation, then the rules should apply, as I think they would under the staff report.

On the other hand, we are somewhat concerned about the ability of a loss corporation to purchase a profitable corporation that has a profit in the form of appreciated assets—unrealized appreciated assets—or other inherent tax liabilities; that is, not profit that is going to come through the normal operation of the business, which again we think should not be restricted, but profit that would come simply by selling off an appreciated asset. And it is in that area that we think that the subcommittee should give some consideration.

Frankly, we are not sure that a workable rule can and perhaps even should—although we are inclined to think that the answer is "should"—be developed to deal with the situation in which a profitable corporation is acquired that has substantial appreciated assets or substantial other inherent tax liabilities that could be realized, recognized, and used by the loss corporation. It is a difficult issue. As I said, we are not sure that there is a solution to it; but it is one that we think does deserve some additional consideration.

Finally, Mr. Chairman, I want to make one comment about section 269 of the code. It is the current law provision that imposes more or less a subjective limitation on loss carryforwards, a tax-avoidance limitation.

The staff report would limit section 269 in case of any transactions which are subject to the proposed limitations contained in the staff report.

I think, from a conceptual standpoint, we believe, and I think we share the staff's belief in this regard, that, to the extent we could eliminate section 269 to bring more certainty to the calculation of the amount of the loss carryforward, that is desirable. And we have indicated that in our prior testimony, and we continue to believe that; that the price of a section 269 undoubtedly will be some uncertainty in the transaction and, thus, a reduction in the price of the loss corporation, to the shareholders of the loss corporation, or, put another way, some undue advantage to the purchasers of the loss corporation.

Nevertheless, in spite of that, with new rules come obviously untested potential for avoidance, and at this point, and until I think we have had experience with a new set of carryover rules, we would not support a substantial restriction in current law section 269. Rather we would hope that after a set of new operating loss rules were in place for some time, that both we and the Congress could reexamine section 269 and then make a determination as to whether the section could be repealed, which should be our ultimate objective, I think.

Mr. Chairman, I am going to stop at this point in time. I want to thank you again for giving us a chance to make comments on the report, not only with respect to the net operating loss provisions, which as I have indicated are the ones that we have our most immediate interest, but with respect to the report in its entirety. We are committed to working with the staff. We have tried to offer our comments as the process has proceeded through staff consideration, and we remain available to do that as the subcommittee and the committee proceeds with fundamental reform in this area.

Thank you.

(Mr. Pearlman's written testimony follows:]

For Release Upon Delivery
Expected at 9:30 a.m. E.D.T.
September 30, 1985

STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the views of the Treasury Department on a report, prepared by the Staff of this Committee, entitled "The Subchapter C Revision Act of 1985." This report, issued in May 1985, contains a set of specific recommendations to make a series of changes to Subchapter C of the Internal Revenue Code. The Treasury Department is interested in and supportive of the effort to reform the current rules applicable to the taxation of corporations and their shareholders, and we applaud the Staff for its excellent work in preparing a comprehensive set of proposals, reduced to statutory language and accompanied by rich explanatory material, to reform and to simplify this area.

We are concerned, however, that enactment of changes of the magnitude suggested by the Staff is for several reasons inappropriate at this time. First, in light of the substantial modifications to the Internal Revenue Code that will be necessary to accomplish fundamental tax reform, we are hesitant to support further extensive changes. Second, the Treasury Department does not believe that the potential economic effects of the Staff's far-reaching proposals have been adequately considered. In this regard, we complement the Committee for soliciting the views of various economists for today's hearing, but we must emphasize that before undertaking major changes in an area as well settled as Subchapter C, these potential effects must be clearly understood. Therefore, with one important exception discussed below, we recommend that the Committee defer passage of extensive changes to Subchapter C until fundamental tax reform has been completed, the resulting statutory changes have become understood by taxpayers and their advisors, and the potential economic effects of the Staff proposals have been more thoroughly documented.

Despite our view that extensive changes to Subchapter C are inappropriate at this time, we believe that serious attention should be devoted this year to the limitations imposed by the Internal Revenue Code on the extent to which a corporation can utilize net operating loss carryovers, excess tax credits, and other tax attributes following certain corporate transactions. The existing limitations were amended extensively by the Tax Reform Act of 1976 ("1976 Act"), but the effective dates of those amendments have been delayed repeatedly in response to criticism and are currently scheduled to become effective on January 1, 1986.

Unlike the proposed Subchapter C changes generally, the limitations on the carry over of net operating losses and other tax attributes have been considered extensively by Congress and the Treasury Department during the past several years. There is general consensus that the existing limitations are wholly inadequate and in need of revision, and that the 1976 Act amendments, which have been debated for almost ten years, also are seriously flawed. Accordingly, the Treasury Department believes that new rules to replace both the existing limitations and the 1976 Act amendments should be developed before January 1, 1986.

In general, the Treasury Department strongly supports the proposal regarding the limitations on net operating loss carryovers and other tax attributes included in the Staff Report. We believe the Staff proposal offers an excellent foundation on which to build a reformed system that can replace the current law and 1976 Act limitations on the utilization of carryovers. Consequently, although we will not at this time discuss the full range of modifications to Subchapter C suggested by the Staff, we will discuss in detail the proposed set of rules governing the extent to which net operating losses and other tax attributes may be utilized following corporate acquisitions.

Background

Under current law, a corporation that incurs a net operating loss in one year generally is permitted to use the loss to offset income earned in the three taxable years prior to and the 15 years after the year in which the loss is incurred. Similarly, a corporation that incurs a capital loss may generally use that loss to offset income earned in the three years prior to and the five years after the year in which the loss is realized. The underlying premise of allowing a corporation to offset a loss incurred in one year against taxable income earned in another year is to provide an averaging device to ameliorate the unduly harsh consequences of a strict annual accounting system. For similar reasons, corporations that are unable to use all their credits against tax in the year in which the credits are earned generally may use such excess credits to offset tax liability in the three prior and 15 succeeding taxable years. Foreign tax credits, however, may be carried forward only five years.

The tax attributes of a corporation, including net operating loss carryovers, net capital loss carryovers, and excess credit carryovers, 1/ generally survive an acquisition of the corporation, because the corporation's tax history is not affected if its corporate status is unchanged. Thus, if a person purchases the stock of a corporation in a taxable stock acquisition, the corporation's tax attributes generally are preserved, unless the acquiring corporation makes a section 338 election. Thus, the ability to use the net operating loss carryovers of an acquired corporation to offset income earned by that corporation in the 15 years after the loss typically is not affected by the stock purchase. If a section 338 election is made, however, the taxable stock acquisition shares most of the characteristics of a taxable asset acquisition from a liquidating corporation, including the fact that the acquiring corporation does not succeed to any of the target corporation's tax attributes. In addition, if a corporation is acquired by another corporation in a tax-free acquisition, the Internal Revenue Code provides that the tax attributes of the target corporation carry over to the acquiring corporation, notwithstanding the fact that the acquired corporation's separate corporate existence may terminate. Finally, tax attributes similarly carry over in the case of a tax-free liquidation of an 80-percent-owned subsidiary.

Section 382 was added to the Internal Revenue Code in 1954 to establish objective tests that would curb "trafficking" in corporations with unused net operating losses. 2/ Congress was

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1/ The credits that are available for carry over include the various business credits, the research credit, and the foreign tax credit.

2/ A similar set of rules is provided in section 383 to limit the use of corporate tax attributes other than net operating losses, such as tax credit carryovers, foreign tax credit carryovers, and capital loss carryovers. For convenience, we will refer in our discussion primarily to net operating loss carryovers. Most of the same principles, however, apply to the other corporate tax attributes.

particularly concerned that profitable corporations were acquiring shell corporations whose principal asset was a net operating loss carryover that could be applied in future years against income unrelated to any business activity of the acquired corporation. 3/

In the Tax Reform Act of 1976, Congress sought to tighten and to unify the provisions of section 382. The 1976 Act amendments were enacted in part because Congress believed that section 382 as enacted in 1954 was ineffective and did not adequately serve its purpose. The effective dates of the 1976 Act amendments, however, have been delayed repeatedly in response to criticism, most recently in the Tax Reform Act of 1984, and are currently scheduled to become effective on January 1, 1986.

Section 382, both as presently in effect and as modified by the 1976 Act amendments, incorporates two sets of rules for limiting the utilization of net operating losses. One set of rules applies in cases of changes of ownership by taxable stock purchase or redemption and the other set of rules applies to acquisitions by tax-free reorganization.

3/ In addition to the objective limitations contained in sections 382 and 383, the carry over of net operating losses, capital losses, and credits may be disallowed under section 269 if the principal purpose of an acquisition of a corporation is tax avoidance by securing the benefit of the losses or excess credits. Thus, section 269 serves as a backstop to prevent misuse of the general carryover limitation provisions. In addition to these statutory limitations, the ability of an acquiring corporation to benefit from the tax attributes of a target corporation by joining with the target to file a consolidated income tax return is limited to some extent by the change of ownership and separate return limitation year rules provided in applicable Treasury regulations. The consolidated return regulations under certain circumstances also limit the ability to benefit from "built-in" losses following an acquisition. Finally, limitations also may be imposed under certain situations by operation of a judicially-crafted continuity of business enterprise test. In Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957), the Court held that net operating loss carryovers would not survive a statutory merger unless the losses were offset against income earned after the merger that was attributable to the same business that produced the loss. Libson Shops arose under the 1939 Code, but its applicability under existing law is unclear. The legislative history of the 1976 Act amendments to section 382, however, provides expressly that the continuity of business enterprise concept articulated in Libson Shops will not survive the effective date of those amendments.

Purchase Rule

Under existing section 382, in the case of redemptions and acquisitions by purchase, 4/ no carry over of net operating losses is permitted if (1) more than 50 percent of the stock of the corporation that incurred the loss ("loss corporation") changes ownership within two taxable years, 5/ and (2) the loss corporation does not continue to carry on substantially the same trade or business after the change in stock ownership. The determination of whether 50 percent of the loss corporation stock has changed ownership is made with reference to the ten largest shareholders. Thus, in a transaction in which loss corporation stock is sold or redeemed, the carry over of net operating losses is prohibited only if there is both (1) insufficient "continuity of interest" by the loss corporation's ten largest shareholders and (2) insufficient "continuity of business enterprise" after the transaction. If either of these conditions does not occur, however, the use of net operating loss carryovers following a stock purchase or a redemption is not subject to any limitations. Thus, for example, all the stock of a corporation may be sold without invoking any limitations under section 382 if the new owners continue the loss corporation's historic business. Therefore, assuming the inapplicability of the Libson Shops doctrine and section 269, the net operating loss carryovers may be used to offset income from new businesses.

The 1976 Act amendments tightened the limitations applicable to taxable acquisitions by removing the requirement that the historic trade or business of the loss corporation be terminated before limitations on carryovers would be imposed. Thus, under the 1976 Act amendments, the limitations would be triggered solely by reference to changes in stock ownership. 6/ Moreover, the 1976 Act amendments would have broadened the definition of

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4/ For purposes of section 382(a), the issuance of new stock does not constitute a "purchase." Thus, the acquisition of a control of a loss corporation through direct issuance of stock does not involve any limitations on the corporation's use of net operating loss carryovers.

5/ Changes of ownership among related persons are disregarded under section 382(a).

6/ The 1976 Act amendments changed the focus from voting stock that was not limited and preferred as to dividends to all "participating stock." In general, participating stock includes any stock that represents an interest in a corporation's earnings and assets that is not limited to a stated amount. This change was intended to prevent the use of "preferred" stock to circumvent the section 382 limitations.

purchase to include capital contributions that increase the percentage of stock owned by a shareholder. These amendments also raised the threshold change of stock ownership from 50 percent to 60 percent in the case of taxable stock purchases, increased to 15 the number of relevant shareholders, and lengthened the "lookback" period. The increase in the threshold from 50 percent to 60 percent was enacted to coordinate the rules applicable to purchases with those applicable to reorganizations, described below. In addition, rather than eliminating all net operating losses once the required change in stock ownership occurred, net operating loss carryovers under the 1976 Act amendments would be gradually phased out as the percentage change in stock ownership increases from 60 percent to 100 percent. Finally, although the 1976 Act amendments did not repeal section 269, the applicable legislative history provides that section 269 would not deny a deduction for a loss that survived section 382, in the absence of a scheme to circumvent the purpose of the limitations.

Reorganization Rule

Under section 382(b) as presently in effect, the carry over of net operating losses generally is limited in the case of certain tax-free reorganizations if the stock in the acquiring corporation that is received by shareholders of the loss corporation after the acquisition represents less than 20 percent of the stock of the surviving corporation. In such a case, the net operating loss carryovers of the loss corporation are gradually reduced based upon the level of the loss corporation shareholders' ownership in the surviving corporation. In particular, for each percentage point below 20 percent received by loss corporation shareholders, the amount of net operating loss carryovers that survive the reorganization is reduced by five percent. It is irrelevant for purposes of the reorganization rule whether the acquiring corporation continues to conduct the trade or business of the loss corporation. Thus, assuming that neither section 269 nor Libson Shops is applicable, the net operating loss carryovers fully survive if the loss corporation shareholders receive at least 20 percent of the acquiring corporation's stock.

Under the 1976 Act amendments, the types of tax-free reorganizations to which section 382 applies would have been expanded significantly to prevent avoidance of the limitation. 7/ This expansion sought to cure one of the most glaring deficiencies in the current limitations. The limitations applicable to tax-free reorganizations would have been strengthened further by increasing from 20 percent to 40 percent the level of stock ownership at which net operating loss

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7/ Under existing section 382, the otherwise applicable statutory limitations may be effectively avoided by using either triangular or stock-for-stock reorganizations.

carryovers would be limited. Thus, the shareholders of a loss corporation would be required to receive at least 40 percent of the acquiring corporation's stock for the net operating losses to be allowed in full. If, on the other hand, the loss corporation's shareholders acquired less than 40 percent of the stock of the acquiring corporation in such a tax-free reorganization, the net operating losses available to the acquiring corporation would be phased out as the loss corporation shareholders' percentage ownership in the surviving corporation declined. As in the case of taxable purchases and redemptions, the limitations applicable to tax-free reorganizations under the 1976 Act amendments would turn solely on changes in stock ownership.

Discussion

Before discussing the Staff's proposal to change the applicable limitations, it is useful to outline briefly the theoretical underpinnings of limitations on the carry over of net operating losses and other tax attributes following the acquisition of a corporation. We also will describe generally the criticism that has been made in response to existing law and the 1976 Act amendments.

Basic Principles

In analyzing the issues raised by the carry over of corporate net operating losses, commentators have suggested the following competing, and somewhat inconsistent, tax and economic policy considerations:

- any rule governing the carry over of tax attributes should be consistent with the historic legislative purpose of the carryover provisions as averaging devices;

- the tax laws should not distort investment decisions and should not create undue bias between diversified and non-diversified entities or between old and new businesses;

- a corporation's ability to carry over net operating losses should not require the Federal Government to be a partner in all businesses. In other words, the rules governing the use of net operating losses should not amount to a Federal subsidy for all such losses;

- the rules applicable to the carry over of tax attributes should prevent "trafficking" in loss corporations;

- the limitations on the carry over of net operating losses and other tax attributes should not result in tax attributes of a corporation becoming more or less valuable in the hands of a purchaser of the corporation than they would have been in the hands of the seller;

- the tax laws should not encourage corporate acquisitions that would not be undertaken on purely economic grounds or discourage those that would be undertaken on such grounds; and
- the rules establishing limitations on carryovers also should provide certainty in determining the extent to which tax attributes will survive an acquisition to prevent a purchaser from obtaining a windfall from the carryover.

Refundability

As is apparent from these principles, the initial question that must be faced is whether any limitations should be imposed on the use of net operating loss carryovers. One can argue that the rules governing the use of net operating losses will not create a bias among various types of entities and businesses and will not distort investment decisions only if all limitations are removed from the utilization of such losses. The furthest move in this direction would be to provide for refundability of net operating losses. In a refundability system, a corporation that incurred a net operating loss would receive a refund from the Federal government equal to the tax savings that would have resulted if the corporation had been able to offset fully the net operating loss in the year incurred against other income.

A provision for direct reimbursement of net operating losses by the Federal government would, of course, eliminate the need for limitation provisions such as section 382. Moreover, such a system would ensure that the benefits of a net operating loss would accrue directly to the entity that suffered the loss.

The adoption of a refundability system also would eliminate the current bias in favor of conglomeration that exists with respect to the deductibility of net operating losses. This bias exists because net operating losses of one business may be offset against profits of another business, thereby reducing the conglomerate's current tax burden. By comparison, a corporation engaged in a single line of business does not receive any tax benefit from a net operating loss until and unless the corporation realizes offsetting income. On a present value basis, such a net operating loss is worth less than a net operating loss that is usable currently. A reimbursement system would eliminate this bias by providing the same after-tax consequences for a net operating loss regardless of the existence of a related profitable enterprise.

Similarly, the current treatment of net operating losses is biased with respect to new investment in favor of established enterprises. An established corporation that incurs a loss on an investment may secure an immediate refund under current law by applying that loss against past taxable profits. A new corporation, in contrast, is unable to utilize a net operating loss until it realizes taxable income. A system of refundability would eliminate this bias by equalizing the tax benefits of losses between new and existing businesses.

While a system of refundability might well make the net operating loss provisions more neutral among various types of enterprises, the Treasury Department does not believe it is advisable to implement such a system. A system of refundability would require the Federal government to become a partner in all investments, a role we believe is inappropriate. Moreover, a system of refundability would pose potentially insurmountable administrative and budgetary problems. For example, verification of the bona fide value of the net operating losses would be imperative, yet extremely difficult and complex.

Free Trafficking

Short of providing direct government reimbursement of net operating losses, one can argue that all limitations on the carry over of tax attributes from one corporation to another, including section 382, should be repealed. Under such a system, profitable corporations would be free to purchase net operating losses from loss corporations. While this free trafficking in corporations with favorable tax attributes would not achieve complete neutrality, it would ensure that most of the benefit of the net operating losses would be realized by those who suffered the economic losses. Consequently, purchasers of loss corporations would not be able to realize profits at the expense of loss corporations or their shareholders.

Unrestricted trafficking in loss corporations, however, would constitute partial and indirect reimbursement of losses. As stated above, we do not believe that the carryover rules were intended to serve the function of providing Federal subsidies, whether direct or indirect, for corporate losses.

We also believe that unrestricted trafficking in loss corporations would go far beyond the legislative purpose underlying a corporation's right to offset a net operating loss incurred in one year against taxable income earned in another year. This right is intended merely as an averaging device to reduce the inequity of a strict annual accounting system.

Although we recognize that both refundability and the unrestricted trafficking in loss corporations might make risk-taking in corporate form more attractive, it is not clear that risk-taking is relatively discouraged under existing tax rules. The unrestricted ability to use corporate tax attributes, including net operating losses, also would encourage the takeover of loss corporations by profitable corporations primarily to obtain the tax benefits of net operating loss carryovers. Purely tax-motivated mergers and acquisitions would have adverse effects on the economy and should not be encouraged.

Alternate Bases For Limitations

Accepting, as we do, that it is appropriate to place some limitations on the carry over of net operating loss carryovers following corporate acquisitions, it is necessary to examine both the triggering events that make any limitations operative and the mechanics of the limitation. The principal triggering events that have been used in the past are continuity of shareholder interest and continuity of business enterprise. The limitation has always taken the form of complete disallowance or partial reduction of the amount of net operating loss carryovers that survive the triggering events.

For purposes of section 382, continuity of shareholder interest may be defined as the continued economic interest of the shareholders of the loss corporation in that corporation or its successor during the taxable years subsequent to the years in which the net operating losses were incurred. Since its enactment in 1954, section 382 has considered continuity of shareholder interest a significant factor in determining whether, and the extent to which, the carry over of net operating losses should be limited. The 1976 Act amendments to section 382, in the furthest move in this direction, established continuity of shareholder interest as the sole factor to be considered in determining the limitation on net operating loss carryovers following a change in ownership of the loss corporation.

The rationale for using continuity of shareholder interest as the basis for limiting carryovers is that a corporation's shareholders generally are the real parties who suffer economic loss when the corporation they own incurs a net operating loss. Thus, a net operating loss carryover should be deductible by the corporation only if such a deduction will reduce the shareholders' economic loss.

We believe that reliance on continuity of shareholder interest as a determinative factor for determining the extent to which carryovers survive a corporate acquisition, particularly as the sole factor as set forth in the 1976 Act amendments, is flawed for several reasons. First, a limitation based on continuity of shareholder interest may be inconsistent with the income averaging function of the net operating loss carryover provisions. For example, net operating losses under current law may result from a corporation's ability to deduct expenses prior to the year in which corresponding items of income must be reported. This mismatching of income and expenses most frequently occurs in the case of assets that are subject to the accelerated cost recovery system. To the extent that net operating losses result from this mismatching of expenses and income, rather than from economic losses, the lack of continuity of shareholder interest should not unduly restrict the ability of the business to use its net operating losses to offset income in subsequent taxable years.

Moreover, a loss limitation rule that reduces available net operating losses by reference to a specified percentage of continued shareholder interest, such as the reorganization rule in existing law and both rules under the 1976 Act amendments, may create undesirable economic effects. For example, if shareholders of the loss corporation are required to own a minimum percentage of the stock of the surviving corporation following a tax-free reorganization, then acquisitions by relatively large corporations are discouraged. In particular, the larger corporations would be denied the use of otherwise available net operating loss carryovers, and would thus be economically motivated to offer less consideration for the loss corporation than would a smaller potential acquirer. Certain acquisitions might thus be discouraged, even though desirable without regard to tax considerations. We do not believe that the limitations on the use of net operating loss carryovers should bias acquisitions in favor of smaller companies or penalize larger companies.

The second criterion upon which the limitation on the carry over of net operating losses has been based is continuity of business enterprise. Under the continuity of business enterprise test, limitations on the carry over of net operating losses are triggered if the business previously conducted by the loss corporation is not continued by the acquiring corporation. This approach is intended to restrict use of net operating loss carryovers to the business activities that produced the losses.

Using the continuity of business enterprise doctrine as a test to determine the availability of net operating loss carryovers also suffers several serious flaws. First, the continuity of business enterprise test is difficult to apply whenever significant new capital or other assets are added to the old business, or where the old business is operated in a different manner. This uncertainty has resulted in costly and time-consuming litigation without clarifying the ambiguous nature of the standard. In addition, it has caused purchasers of loss corporations to reduce the price they pay and gives them an opportunity to realize a profit at the expense of the loss corporation and its shareholders. Thus, the intended beneficiaries of the carryover provisions, those who suffered the loss, do not properly benefit from the carry over of the net operating losses by the acquiring corporation.

Second, using continuity of business enterprise as a triggering event for limitations on the utilization of net operating loss carryovers encourages a loss corporation, or a corporation that purchases a loss corporation, to continue operating an unprofitable business. Such uneconomic behavior should not be encouraged by the tax laws.

Third, even if the continuity of business enterprise test is met, the continuing business may be an insignificant part of the surviving corporation or produce no income, yet the net operating losses incurred prior to an acquisition in some cases can be used in full to offset income from other activities. Such a result, which in the extreme will be tantamount to free transferability of net operating losses, is unsatisfactory.

Criticism of Existing Law and the 1976 Act Amendments

The existing rules of section 382, which rely on both continuity of business enterprise and continuity of shareholder interest, suffer the same defects as their theoretical underpinnings. Moreover, we believe that existing law is deficient because many corporate acquisitions can be structured to avoid the application of the limitations in situations in which there may be no substantial business purpose other than utilization of the net operating loss of the acquired corporation. For example, the limitations imposed by section 382 do not apply to stock acquisitions described in section 368(a)(1)(B). The limitations also may be avoided by acquiring control of a corporation through the use of a subsidiary in a triangular reorganization. While section 269 and the consolidated return regulations may curtail such acquisitions under certain circumstances, existing section 382 inadequately serves its purpose when its provisions can be so easily avoided.

Finally, existing law is subject to deserved criticism because of its inconsistent treatment of acquisitions by taxable stock purchase and tax-free reorganization. For example, net operating loss carryovers are ratably disallowed in the wake of a tax-free reorganization in which there is insufficient continuity of shareholder interest, while the carryovers would be disallowed entirely if a purchase failed the requisite continuity of shareholder interest (assuming the historic business is not continued). In addition, section 382 distinguishes between purchase and reorganization transactions by applying the continuity of business enterprise test only to purchase transactions. Finally, the applicable thresholds on changes in ownership differ depending upon the type of transaction. We believe that the limitation on the use of net operating loss carryovers following purchases and reorganizations, which are often economically equivalent transactions, should be consistent.

The 1976 Act, in an attempt to create a more effective set of rules, eliminated the continuity of business enterprise requirement, coordinated the treatment of acquisitions by purchase and tax-free reorganization, and tightened the rules to prevent avoidance. While the rules enacted in 1976 addressed many of the principal defects of existing law, they have been criticized for their complexity. While complexity in the tax laws should be avoided whenever possible, it is justified if the rules are necessary, theoretically correct, and effective. We believe, however, for the reasons stated above, that reliance on continuity of shareholder interest to measure the extent to which net operating loss carryovers may be used following an acquisition is neither necessary nor theoretically correct.

Description of the Staff Proposals

Preliminary Staff Report

A Preliminary Report released by the Staff of this Committee in September 1983 ("Preliminary Staff Report"), like existing law and the 1976 Act amendments, proposed two sets of rules, one for purchase transactions and a second for certain tax-free reorganizations. The mechanics of the proposal, however, were quite different from current law or the 1976 Act amendments.

The purchase rule provided in general that net operating loss carryovers of the loss corporation would be limited, as to both timing and amount, to the income the loss corporation would have earned had no change of ownership occurred and had the loss corporation begun to earn taxable income at an assumed rate of return on the assets it owned at the time the loss was generated. This rule would apply whenever the ownership of the outstanding stock of a corporation changes hands in a taxable purchase after a year in which the corporation incurred a loss.

Under the proposal, no limitations on net operating loss carryovers would be imposed unless more than 50 percent of the outstanding stock changed ownership after a loss year. In determining whether changes in the corporation's ownership were sufficient to invoke the rule, only shareholders who owned five percent or more of such stock in the carryover year, directly or by attribution, would be considered.

If 100 percent of the stock of a corporation were purchased, the purchase rule would limit the deduction of net operating loss carryovers for each subsequent taxable year to an amount equal to an assumed rate of return times the purchase price of the stock. The proposal specified that the assumed rate of return would be an after-tax rate to reflect the fact that the consideration paid for the stock of the loss corporation would generally cover the value of the assets as well as the net operating loss carryovers. The proposal suggested that the assumed rate of return might be an objective rate, such as 125 percent, of the fluctuating interest rate determined semi-annually pursuant to section 6621.

If more than 50 percent but less than 100 percent of the loss corporation's stock were purchased, the portion of the acquiring corporation's income attributable to the stock that had not been sold could absorb net operating loss carryover deductions without limitation. The remaining portion of the earnings, attributable to the stock that had been purchased, could be offset only in an amount equal to the assumed return on the purchase price of that stock.

Under the Preliminary Staff Report, a separate set of rules would apply to any case in which the stock or assets of a loss corporation were acquired in a tax-free reorganization, for stock of the acquiring corporation, or for stock of a corporation that controls the acquiring corporation. Under the merger rule, the net operating loss carryovers otherwise available would be allowed to offset only the portion of income earned by the surviving corporation after the acquisition that is allocable to the contribution of the loss corporation's assets to the acquiring corporation. This merger rule was intended in principle to permit the use of net operating loss carryovers to the same extent that such carryovers would have been allowed if the loss corporation and the acquiring corporation had contributed all of their assets to a joint venture. The proposal attempted to duplicate the fact that, under such circumstances, only the portion of the joint venture's income allocable to the loss corporation could be offset by that corporation's net operating loss carryover.

After a tax-free reorganization, the merger rule would provide that the portion of the post-acquisition taxable income of the surviving corporation and its subsidiaries allocable to the loss corporation's assets would be determined by reference to the percentage of common stock of the acquiring corporation issued in the acquisition to the loss corporation's shareholders. The percentage of the acquiring corporation's taxable income that could be offset, however, would be less than the percentage of stock of the acquiring corporation issued to the loss corporation shareholders in the acquisition. The reduction was considered necessary because post-reorganization taxable income theoretically allocable to the loss corporation would not be subject to tax to the extent of allowable net operating loss carryovers. As a result, the percentage of the acquiring corporation's stock that would be issued in the acquisition generally would exceed the percentage of taxable income of the acquiring corporation allocable to the loss corporation's assets.

If an acquiring corporation issued stock and paid other consideration in a tax-free reorganization, the proposal contemplates that both the purchase rule and merger rule would apply. Thus, the surviving corporation would be able to utilize net operating loss carryovers in an amount equal to the sum of (i) the value of the other consideration times the applicable rate of return plus (ii) the portion of the surviving corporation's income that is allocable to the stock issued to the loss corporation shareholders.

Final Staff Report

Overview

Unlike the Preliminary Staff Report, the bill included in the Final Staff Report proposes a single rule that would limit the utilization of net operating loss carryovers and other tax attributes following a substantial change of ownership by either taxable purchase or tax-free reorganization. The basic principle of this approach, like the theory underlying both the purchase rule and merger rule suggested in the Preliminary Staff Report, is that the entire net operating loss carryover should be preserved following an ownership change, but a limit should be imposed on the amount of annual income against which the net operating losses can be deducted following the acquisition. In this manner, the Staff proposals attempt to ensure that the use of carryovers after an ownership change is limited to the use that would have been available to the loss corporation had no ownership change occurred and that the value of net operating loss carryovers is therefore neither increased nor decreased as a result of an acquisition. The bill provides in particular that the deductibility of net operating loss carryovers following a substantial ownership change would be limited in each year to an amount equal to the Federal long-term rate times the value of the loss corporation at the time of the ownership change. In general, a substantial change of ownership would be defined as any change, however accomplished, resulting in a greater than 50-percent shift in the ownership of the corporation's equity.

Losses Subject to Limitation

Following a substantial change in the ownership of a corporation, the Staff bill would generally limit the utilization of all net operating losses, capital losses, and credits incurred by the corporation prior to the ownership change. For this purpose, any net operating loss incurred in a taxable year during which a substantial change in ownership occurs would be allocated to the periods before and after the change on a pro rata basis. The bill also would generally limit the utilization of any "built-in loss" on the same basis as net operating losses. The treatment of built-in losses is discussed below in greater detail.

Amount of Annual Limitation

The utilization of net operating losses and other tax attributes in any post-change year would generally be limited by the Staff bill to the product of the value of the loss corporation 8/ immediately before the ownership change multiplied by the applicable Federal long-term rate on the date of the change in ownership. The long-term rate was selected by the Staff because it represents the maximum risk-free rate of return the loss corporation could have obtained and the Staff assumed the maximum use of losses would be desired for the entire 15-year carryover period. Under the Staff bill, the rate in effect on the date of the ownership change would be the applicable rate for all post-change years, regardless of any subsequent fluctuations in the rate. In addition, as discussed in further detail below, the amount of the annual limitation would be increased by any "built-in gains" recognized during the year. If the amount of the annual limitation exceeded the losses deducted for a year, the excess would be carried forward to increase the limitation in subsequent years.

In the event of successive substantial changes in ownership, the bill would provide two rules. If the applicable limitation for the second ownership change were less than the limitation for the first ownership change, the second limitation would replace the first limitation and become the relevant limit on the utilization of all losses arising before the second change. If, on the other hand, the second limitation were greater than the first limitation, the two limitations would operate in tandem. In particular, the utilization of losses arising prior to the first ownership change would continue to be subject to the first limitation, while any losses arising after the first change 9/ would be deductible following the second change to the extent the second limitation exceeded the amount of taxable income that is offset as a result of the first limitation.

8/ The Staff bill would define the value of the loss corporation as the fair market value of the stock of the corporation. According to the Staff explanation, the price paid for a substantial portion of a corporation stock would be indicative of the stock's fair market value. In view of the difficulty that may arise in valuing a corporation's equity, consideration should be given to the creation of a statutory presumption that the value of a loss corporation would be presumed to be equal to the purchaser's "grossed-up" basis in the loss corporation stock plus assumed liabilities in any case in which at least 80 percent of the loss corporation stock is acquired during a relatively short period.

9/ Any losses recognized between the two changes that were treated under the rules discussed below as built-in losses with respect to the first change would continue to be subject to the first limitation. No losses recognized after the second change, however, would be treated as built-in losses with respect to the first change.

Capital Contributions

Because the extent to which net operating loss carryovers may be utilized following an ownership change is dependent, under the Staff bill, upon the value of the loss corporation, the bill would provide a rule designed to prevent that value from being inflated in anticipation of an ownership change. In particular, any capital contribution made at any time as part of a plan the principal purpose of which is to avoid the limitations would not be taken into account in determining the value of the loss corporation or in applying the built-in deduction rules. Further, the bill would provide that any capital contribution made during the two years preceding an ownership change would be presumptively treated as part of a plan to avoid the limitations, except as provided in Treasury regulations, and thus would not be taken into account in determining the loss corporation's value.

Investment Companies

Under the bill, a special "anti-abuse" rule would be provided to prevent the utilization of net operating loss carryovers following a substantial change in the ownership of a corporation that is essentially a nonoperating corporation with favorable tax attributes. In particular, the bill would disallow the use of net operating loss carryovers and other tax attributes following a substantial change in the ownership of any corporation if two-thirds or more of the corporation's total assets consist of assets held for investment.

While no definition of the phrase "assets held for investment" is provided in the bill, the explanation prepared by the Staff states that assets that had been used in an active trade or business would not be considered investment assets, regardless of whether the business is actively conducted at the time of the substantial change in ownership. The investment company rule also would not apply if a corporation sold its active business assets shortly after a substantial change in ownership. The Staff explanation states, however, that the step transaction doctrine generally would apply in determining whether a corporation held assets for investment. If, therefore, a corporation that owned active business assets agreed to dispose of those assets prior to a change in the corporation's ownership, but delayed the disposition until after the ownership change, the step transaction doctrine would apply to collapse the disposition of the assets and the change in ownership. The corporation would thus be treated as holding its assets for investment and would not be permitted to utilize any net operating loss carryovers following the ownership change.

Built-in Gains and Losses

The bill would provide a comprehensive set of rules regarding the treatment of "built-in" gains and losses. Built-in gains and losses are simply unrealized differences between the value and adjusted basis of assets that exist at the time of a substantial change of ownership. In general, the bill would treat built-in losses in the same manner as net operating losses incurred prior to the change of ownership, and would thus subject the deductibility of those losses to the annual limitation. Conversely, built-in gains would be treated as if they had been recognized prior to the change of ownership, and were thus able to be offset by net operating losses incurred prior to the ownership change. Accordingly, the amount of built-in gains recognized after the ownership change would increase the limitation for that year.

The bill would provide several simplifying assumptions and a de minimis rule to mitigate the complexities associated with special treatment of built-in gains and losses. First, a corporation would be treated as having built-in gains or losses only if the fair market value of all its assets immediately before the change in ownership was more or less, respectively, than the aggregate basis of its assets. Thus, a corporation would have either a net built-in gain or a net built-in loss, and would not have to account for both built-in gains and losses with respect to individual assets. In effect, therefore, the bill would net a corporation's unrealized gains and losses against each other for purposes of these rules. Moreover, a de minimis rule would provide that a corporation would not have to account for built-in gains or losses if the aggregate net built-in gain or loss was 25 percent or less of the fair market value of the corporation's assets. This rule would confine the complexity of accounting for the built-in gains or losses to those corporations for which net built-in gains or losses are significant.

If a corporation has an aggregate built-in loss that exceeds 25 percent of the fair market value of its assets, then any losses recognized in the five years following an ownership change (the "recognition period") would be presumed to be built-in losses, and would thus be subject to the applicable annual limitation in the same manner as net operating losses incurred prior to the ownership change. A loss recognized during the recognition period would not be treated as a built-in loss only if the corporation was able to establish that the loss arose after the ownership change.

If, on the other hand, a corporation has a built-in gain that exceeds 25 percent of the fair market value of its assets, then gains recognized during the recognition period would be treated as built-in gains if the taxpayer was able to establish that the gain arose before the ownership change. 10/ Any such recognized built-in gains would be added to the applicable limitation, and would thus permit the corporation to offset the gain without limitation against losses incurred prior to the ownership change.

10/ Under the bill, therefore, while losses recognized during the recognition period are presumed to be built-in, any gains recognized during that period are presumed not to be built-in, unless the taxpayer was able to establish to the contrary.

Title 11 Bankruptcy Proceedings

Under the general provisions of the Staff bill, an exchange of stock for debt would constitute a substantial change of ownership if the creditors participating in the exchange received more than 50 percent of a corporation's stock. In a typical bankruptcy situation, therefore, the limitations would become applicable upon the acquisition of control by the creditors. Because the value of an insolvent corporation's stock would be zero, the applicable limitation would be absolute.

Recognizing the facts that the creditors of a loss corporation are often the economic equivalent of shareholders, that a shift in status from creditor to shareholder may have occurred gradually over an extended period, and that the Congress has in the past provided insolvent corporations with various incentives to rehabilitate themselves, the Staff bill would provide a limited exception from the strict application of the underlying theory for corporations that experience an ownership change in the course of a Title 11 or similar proceeding. In particular, if the shareholders and creditors of such a corporation immediately before any exchange of stock for debt own at least 50 percent of the stock of the corporation after the exchange, then no limitations on the post-exchange use of net operating loss carryovers would apply. In effect, therefore, the bill treats the creditors of a corporation in a Title 11 proceeding as shareholders.

Extending the treatment of these creditors to its logical conclusion, the bill would treat the interest paid to such creditors as dividends and any accrued interest with respect to such debt would be eliminated from the corporation's surviving net operating loss carryovers. Thus, the bill would provide that the net operating loss carryovers of a corporation entitled to this relief would be reduced by the amount of interest paid or accrued by the corporation during the three years preceding the ownership change with respect to any debt exchanged for stock in the Title 11 proceeding.

Finally, the bill would provide an additional limitation on corporations that qualify for the Title 11 exception. If a formerly insolvent corporation experiences a substantial change of ownership within two years of the Title 11 proceeding, then the limitation following the second ownership change would be absolute. In this manner, the bill assumes that any value of such a corporation's stock must be the result of capital contributed by the new owners. Because capital contributions made two years prior to an ownership change are generally ignored under the bill, the value of the stock at the time of the second ownership change must be reduced by the amount of such contributions. Accordingly, the bill would assume that the value of the corporation's stock was zero and no net operating loss carryovers could be utilized following the second change.

Substantial Change in Ownership

The limitations imposed under the bill would generally become applicable when the shareholders of a loss corporation change by more than 50 percentage points during any three-year "testing period." In the case of any change in the shareholders' respective stock 11/ ownership by purchase, redemption, new stock issue or other means, the limitations would apply if, immediately after the change, the value of stock owned by the five-percent shareholders has increased or decreased by more than 50 percentage points over their stock ownership at any time during the three-year testing period. In the case of a reorganization, 12/ the limitations would apply if, immediately after a reorganization, the value of the stock in the surviving corporation owned by shareholders of the loss corporation is more than 50 percentage points less than the value of the stock of the loss corporation owned by the shareholders at any time during the testing period. In general, therefore, the limitations would apply following a reorganization unless the shareholders of the loss corporation did not maintain control of the surviving corporation.

The bill would specify a series of transactions that would not be taken into account in determining whether an ownership change has occurred. Exceptions would be included for transfers by gift, inheritance, bequest, or by reason of divorce or separation. The acquisition of employer securities under an employee stock ownership plan or other qualified plan also would be disregarded.

Other Limitations

The bill would provide that section 269 would not apply to disallow any loss deduction or credit after an ownership change to which the proposed limitations apply. The Staff explanation also states that the *Libson Shops* doctrine would have no continuing applicability in determining the extent to which net operating loss carryovers may be used following an ownership change. Finally, the Treasury Department would be directed to consider the extent to which the consolidated return regulations would be modified to reflect the proposed limitations.

11/ The bill would define stock as any stock other than preferred stock described in section 1504(a)(4).

12/ Reflecting the new definition of acquisitions proposed by the Staff in other areas, the bill refers to a "qualified asset acquisition." If the proposed limitations were enacted separate from the other Subchapter C changes, appropriate modifications in the definition would of course be necessary.

Detailed Analysis of the Proposal

Overview

The Treasury Department strongly supports the method of limiting the utilization of net operating loss carryovers and other tax attributes following a substantial change in a loss corporation's ownership that is proposed in the Final Staff Report. Following publication of the Preliminary Staff Report, we testified in general support of limiting the use of net operating loss carryovers after an acquisition by reference to the assumed future earnings on the loss corporation's value. We stated, however, that the mechanism preliminarily proposed by the Staff, which as described above contemplated one rule applicable to reorganizations and a second rule applicable to stock purchases, could be improved and simplified by adoption of a single rule applicable to all acquisitions. We continue to believe that a single rule, as now proposed by the Staff, is preferable to the more complicated approach, and we are confident that the proposal made in the Final Staff Report generally offers the best means of reforming the inadequate current law limitations on the carry over of net operating losses and other tax attributes. Accordingly, we urge the Committee to adopt the proposed limitations in substantially the form proposed by Staff. We believe, however, that several minor changes, discussed further below, should first be made.

Proper Rate Of Return

Once an approach limiting the utilization of carryovers based upon a percentage of value is adopted, the most important decision is to determine the rate of return that should be used to set the annual limitation on the use of net operating losses and other tax attributes. 13/ In order to ensure that

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13/ An explicit choice of the applicable rate of return would be unnecessary under an alternative approach that would limit the utilization of net operating loss carryovers and other tax attributes after either a purchase or reorganization to an amount equal to the purchase price of the loss corporation. This approach is arguably the equivalent of the Staff proposal as the purchase price can be viewed as the discounted present value of the stream of income expected to be earned with respect to the loss corporation's assets. By limiting the total amount of net operating loss carryovers and other tax attributes that would survive a purchase or reorganization, this alternative would not impose any restriction on when the available carryovers can be utilized. Thus, under this alternative, the entire net operating loss carryover could be deducted by the corporation in the year immediately following the change of ownership, regardless of utilization of the net operating loss carryovers would not be affected by an acquisition and that the value of the carryovers would not be increased or decreased as a result of an acquisition, the theoretically correct limitation rate would be the rate at which the loss corporation would have used the net operating loss carryover if no acquisition had occurred. In our view, however, a rule that would in each case require the identification of the earnings attributable to the loss corporation's assets would not be administrable. Several approaches for approximating the theoretically correct rates have been suggested.

First, the limitation rate could be based on a market interest rate. This approach, which forms the basis of the bill proposed by the Staff, was first proposed by the American Law Institute. Such a market-rate based approach implicitly assumes that a loss corporation could have earned this rate on its assets and, therefore, could have absorbed its net operating loss

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13/ Continued: the amount of income attributable to the loss corporation's assets or the age of the carryovers. While it can be argued that this approach is no more generous than the Staff proposal when viewed on a present value basis, it does not attempt to reflect the manner in which the loss corporation could have used the net operating loss carryovers. In this way, the approach violates the principle that net operating loss carryovers should become neither more nor less valuable in the hands of the acquiring corporation, the theoretical basis underlying the proposed limitations. Moreover, by allowing the entire net operating loss carryover to offset income of the acquiring corporation this approach may favor large acquirors at the expense of smaller corporations. A similar approach, which has been suggested by the American Bar Association, would generally limit the utilization of net operating loss carryovers, capital loss carryovers, and excess tax credits to 24 percent of the loss corporation's value per year for the five-year period following the change of ownership. This alternative is based on the view that the purchase price represents the correct limitation, but that it should be spread over some period of time to avoid undue potential acceleration of the carryovers. Because this approach is premised on the view that the purchase price reflects the correct limitation, this alternative suffers the same flaws as the purchase price limitation described above. Because adoption of either of these alternatives would in varying degrees potentially accelerate use of net operating loss carryovers and other tax attributes following an acquisition and would thus violate the sound theoretical base underlying the Staff proposal, the Treasury Department does not support either approach.

carryovers at this speed. The loss corporation could obtain a market rate of return, for example, by selling its assets and investing the proceeds in Treasury bonds. The use of a market rate of return, as suggested below, however, may violate the principle that net operating losses should not become more or less valuable as a result of an acquisition in cases in which the loss corporation could not or would not earn a market rate on its value.

An alternative approach for setting the limitation rate would be based on the average rate at which corporations actually absorb net operating loss carryovers. The determination of this average absorption rate presents several difficulties. In particular, a decision would have to be made concerning the group of corporations that should be used to determine the average rate. Most loss corporations continue to experience losses and continue to increase, rather than absorb, their net operating loss carryovers. If this group of corporations were used to determine the average rate at which net operating loss carryovers are absorbed, the limitation rate would be set at or near zero. A more generous assumption would be that all loss corporations that are acquired have "turned around," and experience, or are about to experience, taxable profits. Preliminary analysis indicates that, in 1981, corporations with taxable income that used net operating loss carryovers absorbed an average amount of such carryovers equal to approximately 5.5 percent of their book net worth. An even more generous assumption would be that an acquired loss corporation is not generally different from the average taxpaying corporation. Preliminary analysis indicates that the average absorption rate for all corporations was approximately 6.5 percent of book net worth in 1981. In short, the average absorption rate approach suggests that the limitation rate should be in the range of zero to seven percent.

Whether the limitation rate to be specified is based on an average absorption rate or on a market interest rate, an adjustment may be necessary to avoid double counting, if the limitation, for administrative reasons, were based on the purchase price of the stock or the value of the corporation's equity. Because the proposed rule is designed to reflect the income that could have been earned by the corporation's productive assets and because the purchase price or value of the corporation's stock will reflect the value of the net operating loss carryover and other tax attributes as well as the value of the assets, the stock value used to compute the limitation theoretically should be adjusted downward to eliminate the value of the net operating loss carryovers and other tax benefits.

Because adoption of a single rate of return represents only an approximation of a corporation's actual return on its assets, the limitation imposed under the Staff approach will be accurate only on average and, therefore, no particular rate can truly be considered the correct rate. Recognizing the potential adverse effect that an averaging approach may have on specific transactions, we believe that the rate selected should not be set at the lowest rate that is theoretically justified. Rather, the rate selected should reflect the inherent imprecision of the approach, and the facts that any corporation may elect to earn a market return by selling its assets and investing the sales proceeds in financial instruments and that any specific corporation may earn a rate of return that is greater than the average return. At the same time, the rate selected should not be so high as to provide an overly generous limitation. In this regard, while we believe that the rate selected by the Staff, the long-term Federal rate, represents a reasonable choice, we believe that the rate should instead be set at the Federal mid-term rate. Such a rate, in practice, often represents a mid-point in the range of possible rates and, in our view, would better reflect the competing considerations that must be balanced.

Capital Contributions

As discussed above, the theory underlying the Staff proposal is generally to limit the utilization of net operating losses and other tax attributes following an ownership change to the earnings attributable to the value of the loss corporation at that time, as that value represents the pool of capital that suffered the losses. The Staff bill would thus properly provide a safeguard to prevent historic shareholders from intentionally inflating the value of the loss corporation in anticipation of a change in ownership.

While we agree that a limitation on infusions of capital is necessary, we believe that the rule proposed by the Staff may create too much uncertainty and should thus be narrowed slightly. In particular, we agree that any capital contribution made during the two-year period preceding an ownership change should be ignored in determining a loss corporation's value, for purposes of both computing the applicable limitation and applying the built-in gain or loss de minimis rule. Moreover, we agree that contributions of property made during the two-year period also should be disregarded in computing the net built-in gain or loss. Because many capital contributions will be motivated by concerns unrelated to the application of subsequent limitations on the use of net operating loss carryovers, such as contributions made in the ordinary course of business, we also believe that Treasury regulations should be permitted to provide exceptions from the rule for certain contributions that are not made in anticipation of an ownership change.

While this approach is virtually identical to the proposal, the Staff bill would provide further that capital contributions made more than two years before an ownership change also would reduce the loss corporation's value if the principal purpose of the contribution, among other prohibited purposes, was to increase the ability of the loss corporation to utilize net operating loss carryovers following an ownership change. We believe that the limited benefits to be gained by attempting to police capital contributions made more than two years before an ownership change is outweighed by the uncertainty such a provision would cause. In this regard, the relationship between the investment company rule discussed below and this capital contribution rule should be understood. For the reasons discussed below, we believe that any significant abuse potential created by limiting the capital contribution rule to a two-year period would be cured by a slightly modified investment company rule. Accordingly, we recommend that capital contributions made more than two years before an ownership change should be outside the scope of the rule governing capital contributions.

Investment Companies

An important issue that must be confronted when formulating limitations on the utilization of net operating loss carryovers is whether a loss corporation that has converted operating assets into investment assets should be able to transfer its net operating losses incurred with respect to the operating assets. The Staff bill, in order to prevent purely tax-motivated acquisitions of such corporations, would prohibit the carry over of all net operating losses following a change in the ownership of a corporation two-thirds or more of the assets of which were investment assets at the time of acquisition.

We believe that, in theory, a corporation owning only investment assets should be able to retain and to transfer its net operating loss carryovers to the same extent as a corporation that owns primarily operating assets, so long as the rules relating to contributions to capital and new stock issues prevent avoidance of the applicable limitations. Indeed, in the context of an approach based on an interest-like rate of return on the loss corporation's value, it is particularly difficult to distinguish between a loss corporation that continues to own its operating assets and one that has converted those assets into passive investment assets. We also are concerned, as reflected by the absence of any precise definition in the Staff bill, that it would be difficult to define the term investment assets in many industries, including banking, insurance, and securities. Finally, applying special rules to corporations that convert operating assets into investment assets may have the undesirable effect of encouraging loss corporations to retain unprofitable businesses rather than convert them into more liquid investments.

The unlimited ability to sell a corporation the assets of which consist of only investment assets and net operating loss carryovers, however, would be perceived as being abusive and thus might affect the public's view of the tax system. Moreover, the public may perceive investment assets held by an acquired corporation as merely a reduction in its purchase price or acquisition value. Accordingly, we do not oppose a rule limiting the carry over of net operating losses by companies that own substantial investment assets.

We believe, however, that the provision proposed by the Staff may be both too harsh in some circumstances and too lenient in others. In particular, we believe that the "cliff effect" caused by completely eliminating the net operating loss carryovers of a corporation that holds two-thirds or more of its assets for investment may be too harsh. Yet the two-thirds threshold test may be too generous in other instances where the perceived abuse at which the rule is directed is present, but the loss corporation's investment assets fall below that threshold. In some respects, such investment assets may in fact be viewed as a partial reduction in the purchase price (or value) of the loss corporation stock.

Consequently, the Treasury Department believes that an appropriate investment company rule would provide that, for any corporation that owns substantial investment assets 14/ (e.g., at least one-third of its value), the investment assets should be disregarded for purposes of computing the applicable limitation on the post-change utilization of net operating losses. 15/ Such investment assets also should be disregarded in determining whether a corporation has a net built-in gain or loss and in applying the built-in gain or loss de minimis rule. In this manner, the cliff effect inherent in the Staff's approach

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14/ The Staff explanation states that assets held in an "investment business," however active, would constitute investment assets. We believe this statement should be modified to ensure that the bill provides clearly that the investment company rule would not operate automatically to deny the availability of net operating losses to banks, insurance companies, and other financial institutions. Depending upon the scope of any such exception applicable to financial businesses, however, consideration should be given to applying a stricter capital contribution rule to such corporations.

15/ In this regard, we believe consideration should be given to disregarding investment assets only to the extent they exceed loss corporation indebtedness. For those corporations that own investment assets in excess of the threshold, consideration also could be given to disregarding investment assets only to the extent they exceed some floor below the threshold.

would be avoided and the investment company rule would apply to some extent to all corporations that own relatively large amounts of investment assets. Finally, in order to avoid difficult valuation problems, consideration should be given to using basis, rather than value, in determining the amount of non-readily tradable investment assets held by a corporation.

Built-in Gains and Losses

As reflected in the Staff's proposal, a built-in loss is economically equivalent to any pre-acquisition net operating loss, and, in the Treasury Department's view, should be subject to the same limitations as net operating loss carryovers and other favorable tax attributes. Similarly, if a corporation with appreciated assets and net operating loss carryovers is sold and the limitations become applicable, pre-acquisition net operating loss carryovers should be available to offset without limitation any income resulting from the realization of built-in gains.

We recognize that the theoretically correct treatment of built-in gains and losses described above may entail significant complexity. Most importantly, special treatment of built-in gains or losses will in many circumstances require valuation of a corporation's assets. Consequently, as we have testified in the past, appropriate de minimis rules and simplifying assumptions must be carefully considered. In this regard, the Treasury Department believes the Staff proposal generally represents a sound method of accounting for built-in gains and losses. In particular, we support the concept of netting built-in gains against built-in losses and thus requiring corporations to account for either built-in gains or built-in losses, in an amount not exceeding the net built-in amount. Moreover, we support a de minimis rule of the magnitude proposed by the Staff.

We believe, however, that the Staff bill is deficient in limiting its scope to built-in gains or losses recognized after the ownership change and, with respect to so-called built-in deductions, providing only that the Secretary of the Treasury would be authorized to prescribe appropriate regulations. In the view of the Treasury Department, the applicable statutory provisions should state affirmatively that built-in deductions, including deductions that accrue prior to an ownership change as well as a portion of depreciation deductions attributable to assets with a basis in excess of value, should be accounted for in the same manner as recognized built-in losses and subject to the applicable limitation. An issue this important should not be left solely to regulations.

Although we recognize that special treatment of built-in deductions, particularly depreciation, may require more detailed asset valuation than the Staff bill, such deductions are usually more significant than recognized losses and should be subject to the applicable limitation. We would be happy to work with the staff in devising the statutory rules that would be necessary to account correctly for these deductions.

Title 11 Bankruptcy Proceedings

The general approach reflected in the Staff bill suggests that no net operating loss carryovers should be available following a substantial change in the ownership of an insolvent corporation. In particular, because the value of the loss corporation at the time of the ownership change would presumably be zero, the annual limitation would be absolute. The bill, however, provides a special exception for corporations that experience an ownership change in the course of a Title 11 or similar proceeding. In summary, the Staff bill treats creditors of such a corporation as if they were shareholders. Thus, no ownership change is considered to have occurred following an exchange of debt for stock in a Title 11 proceeding, if the creditors and shareholders together retain control of the corporation.

The Treasury Department generally agrees that the creditors of an insolvent corporation are frequently the parties that economically bear the losses that are reflected in the net operating loss carryovers and are thus analogous to shareholders, and that, moreover, their shift in status may have occurred gradually. Consequently, we support the concept that an exception from strict application of the rules should be provided for insolvent corporations and that certain creditors of such corporations may be viewed as shareholders.

We also support the provision in the Staff bill providing that no carryovers would survive a second ownership change within two years of an exempted change that occurred in the course of a Title 11 proceeding. In our view, any increase in the value of a formerly insolvent corporation that occurs within two years of an insolvency proceeding is fairly assumed to be the result of capital contributions made during the two-year period. Because capital contributions made during the two years preceding an ownership change are generally disregarded, the applicable value of such a formerly insolvent corporation at the time of the second change is properly assumed to be zero. While we believe an exception from application of the general rules is appropriate, a further exception from application of the theory upon a successive change outside a Title 11 or other insolvency proceeding is neither necessary nor justified.

Although we generally support the provision in the Staff bill applicable to Title 11 proceedings, we have several concerns. First, we believe that only historic creditors should be taken into account in determining whether the exception applies to a loss corporation. The Staff bill, however, provides the exception whenever the shareholders and any creditors of a loss corporation, new or old, retain control following a Title 11 proceeding. In our view, only the historic creditors are fairly assumed to be parties who economically suffered the loss and who are thus analogous to loss corporation shareholders. Accordingly, we believe that allowing new creditors to take advantage of this exception is not justified. Perhaps more importantly, however, extending the exception to new creditors might permit certain abusive transactions.

We also are concerned that resort to Title 11 proceedings may be improperly encouraged by the Staff bill and that informal workouts would be discouraged. We recognize, however, that an informal workout rule must be carefully crafted to ensure that it cannot be used by solvent corporations to avoid application of the general limitations and that it is not unduly complex and difficult to apply. We would be pleased to work with the Committee in refining the Staff proposal, if possible, in a manner that would balance these competing concerns.

Acquisitions by Loss Corporations

In the Treasury Department's view, the primary difference in scope between the approach described in the Preliminary Staff Report and the bill contained in the Final Staff Report is the fact that the Staff bill, because it encompasses only a single rule based on a substantial change of ownership, does not affect acquisitions of tax-paying corporations by relatively large loss corporations. 16/ In summary, under the definition of substantial change of ownership, a stock acquisition of an equally-sized or smaller tax-paying corporation by a loss corporation would not invoke any limitations because the loss corporation shareholders would have maintained the sufficient 50-percent continuity of interest in the surviving corporation.

There are two classes of corporations that could be acquired by relatively large loss corporations in the manner suggested above. First, a loss corporation could acquire a corporation that is expected to produce taxable income that could be offset by the acquiring corporation's net operating loss carryovers. Second, a loss corporation could acquire a corporation that has substantially appreciated assets or other inherent tax liability, the recognition of which could be offset by the acquiring corporation's net operating loss carryovers.

Under the Final Staff Report, as under current law, no meaningful limitations are imposed upon the types of acquisitions described above. The issue which thus arises is whether the Report is deficient is this respect and, if so, whether the Staff bill should be modified to impose some limitations in such circumstances.

Under the Staff bill, no restrictions are generally imposed on the ability of a loss corporation to rehabilitate itself through contributions to capital by the corporation's historic shareholders. A loss corporation with capital contributed by historic shareholders is thus permitted to purchase assets, including an entire corporation, and offset net operating loss carryovers against the income from those assets. In the Treasury

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16/ If the acquiring loss corporation were smaller than the acquired corporation, however, the loss corporation shareholders would own less than 50 percent of the surviving corporation and the utilization of its net operating loss carryovers following the acquisition would thus be limited.

Department's view, this approach is appropriate in the case of purchases, and there is no reason in this regard to distinguish acquisitions of corporations in exchange for loss corporation stock from purchases for cash. Therefore, unless the loss corporation's shareholders surrender control in a stock acquisition, we believe no limitations should in general be imposed on the loss corporation's ability to acquire a tax-paying corporation.

We are somewhat more concerned, however, by the ability of a loss corporation to acquire a corporation with substantially appreciated property or other significant inherent tax liability and to offset the resulting tax with net operating loss carryovers. While we recognize that this is an exceedingly difficult issue, we believe that some consideration should be given to the manner in which this ability could be circumscribed. If a suitable approach can be developed, however, we believe it should be incorporated into the Staff bill.

Other Limitations

Under the Staff bill, section 269 would not be applicable to any transactions that were subject to the proposed limitations. While the Treasury Department believes that the uncertainty created by section 269 is undesirable and often causes purchasers of loss corporations to reduce the price they offer to the loss corporation shareholders, giving the purchasers a potential profit at the expense of such shareholders, we cannot at this time support a substantial restriction in the scope of section 269. We are particularly concerned that the adoption of a new set of limitations without the potential availability of section 269 may result in unanticipated planning opportunities. After we have gained some experience with the efficacy of the new limitations, however, we should reconsider whether the continued applicability of section 269 remains justified. 17/

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This concludes my prepared remarks. I would be happy to respond to questions.

17/ We are similarly of the view that, at this time, the separate return limitation year and the consolidated return change of ownership rules should remain applicable. After experience with the new limitations is gained, the Treasury Department, as suggested in the Staff explanation, would reconsider the continued need for these regulations or whether any modifications would be appropriate.

Senator **Chafee**. Thank you, Mr. Pearlman.

As is the custom here, we let the Treasury Department go on in some detail, because you represent the government here. I will caution the later witnesses that they will have to abide by the clock, because we do have 17 more witnesses after this.

But let me just ask you a couple of quick questions, Mr. Pearlman.

As I understand the Treasury's position on the general utilities doctrine, you don't want to deal with that yet; you want more study, more time. Is that fair? Or do you want to wait until after the tax reform? I guess you said you would prefer to deal with it after tax reform.

Mr. **Pearlman**. I don't want a quick response or a yes or no response to that question to be glib in terms of general utilities. It is an extremely important issue to Treasury, as well, I think, to the Finance Committee.

Let me try to respond this way: If the acquisitive reorganization provisions that are contained in the staff report were to be enacted, it is clear that a repeal of general utilities is essential. It may be important to repeal general utilities even in the absence of a change in the acquisitive reorganization provisions.

In doing so, there are significant consequences. One is a substantial strengthening of the current corporate double tax—of the current corporate tax, and therefore, of the double tax. We think that is an important issue. It is one that I don't want to put in the form of further time to consider, but it is an important issue before the committee.

We are particularly concerned about the double taxation of liquidation proceeds; we have testified to that effect previously, and we remain concerned. The staff has sought to deal with that. I don't want to sit here today and say the staff's solution to our concern is unsatisfactory, because I think we are not quite that far.

General utilities is a significant issue. The committee may well determine that it wants to proceed with a change in the rules regarding gain recognition on the disposition of assets by a corporation, the general utility rule, in the absence of the acquisitive corporation rules.

I guess I would respond to you, Mr. Chairman, saying that, if the subcommittee were to choose to proceed with general utilities, at least we think the staff report is aimed in the right direction. I think that area, if the policy issues were resolved, could be enacted. I do not think it is an essential change in the law at this point—essential change in the law unless the acquisitive reorganization provisions were also to be enacted at this point in time.

Senator **Chafee**. Now, we got an estimate earlier this year, in April, from the Joint Committee on Taxation that the continuation of the general utilities doctrine costs the Treasury about $61 billion over 5 years. That is $12 billion a year. Do you have a different estimate? Do you quarrel with that estimate?

Mr. **Pearlman**. I can't quarrel with the estimate. Frankly, I don't think Treasury has ever done an estimate on the proposed repeal of general utilities, so I simply can't comment on it.

Senator **Chafee**. Now, some witnesses are going to suggest that these proposals that we have come up with here today—the staff recommendations—be delayed until some effective date, to give Treasury time to get out regulations. If we were to do that, would Treasury come out with regulations, or would you simply wait until the proposals became effective? In other words, is there any point in the delay?

Mr. PEARLMAN. I am not sure whether you are asking me the question in terms of the entire report or just the net operating loss provisions.

Senator CHAFEE. Well, let's say we did the entire report.

Mr. PEARLMAN. Well, let me just say that I think we all need to recognize that if an effective date is delayed until there are regulations on an entire revision of subchapter C, we are going to be waiting a while, I would suspect.

Let me make this observation: I think it is quite appropriate for taxpayers, practitioner groups, to say that with respect to areas where substantial administrative interpretation is needed for rules to be workable, or in areas where there is substantial delegation of authority to regulations, such as the one I mentioned in connection with built-in gains and losses, I think it is quite appropriate for the Congress to say, "Look, if the Treasury can't get the regulations out, how can you expect taxpayers to comply with the new rule?" And I think it would be appropriate, in those instances, to consider delays in effective dates. I think it is impractical, however, to think in terms of a broad delay in the effective dates of a change in Subchapter C until regulations come out, or one might find that those changes never come into effect.

Senator CHAFEE. How about just the NOL?

Mr. PEARLMAN. In the NOL area the first thing we would do is to urge the subcommittee not to adopt the staff report that simply delegates regulatory authority to the Treasury Department. We think that is not appropriate.

If the committee were to give us interpretive authority only—that is, set out rules in the statute that are somewhat more specific, and I can't give you a clear answer—then I think it is going to depend on how specific those rules are. I think if the members of the subcommittee were comfortable in terms of the input it receives from practitioners, taxpayers, that the rules are clear enough that transactions can proceed based on those rules, then I would say, "No, don't defer the effective date." If there are areas within those rules where further interpretation is needed, then there may be some need to do that.

Senator CHAFEE. All right. My time is up.

Senator Danforth.

Senator DANFORTH. Ron, you have urged us, as part of the tax bill which I guess eventually will pass, to include only that part of this report, or a modification of it, as deals with the net operating loss carryforward problem, right?

Mr. PEARLMAN. Yes, Senator. That is our recommendation at this point. The net operating losses are a very important issue and do need to be dealt with.

Senator DANFORTH. Do you think that time is something of the essence with respect to the net operating losses?

Mr. PEARLMAN. Yes; you know, as with all of these areas, they are very difficult areas. And if you examine the net operating loss area, you find that decisions have to be made, lines have to be drawn, and that we could take another decade to do that.

Senator **Danforth**. We have taken a decade, right?

Mr. **Pearlman**. This is an area where we have taken a decade, and in my judgment that is unsatisfactory. This is an area where I think current law is not satisfactory. I don't think it is satisfactory for either taxpayers or the Government. It is an area where I think now, as I have indicated previously, there seems to be some consensus. It is an area where I think the staff of the Finance Committee has taken us a long way towards having workable rules; and so, we would strongly urge you to consider the net operating loss area.

And I am very encouraged by the fact that the Ways and Means staff had included the net operating loss area in its fundamental reform options.

Senator **Danforth**. Would there be any revenue effect one way or another in changing 382?

Mr. **Pearlman**. If you measure it from a pre-1976 law baseline, the answer is Yes. I don't know what that revenue effect is; I can provide that to you. I just don't know what it is off the top of my head. If you measure it from assuming the 1976 rules are in effect, for example, they go into effect January 1, 1986, then I am not sure there would be any revenue effect.

Senator **Danforth**. Could you find out?

Mr. **Pearlman**. Certainly.

Senator **Danforth**. It would seem to me that it would, if anything, gain revenue, but it would probably be about a wash, wouldn't you think?

Mr. **Pearlman**. I think your judgment is right if you measure it from current law without the 1976 rules in effect. But if you hypothesize that the——

Senator **Danforth**. You can't hypothesize that, can you? I mean, it is 10 years ago.

Mr. **Pearlman**. Well, I guess what you are saying when you make that comment is that you assume Congress would defer those rules again.

Senator **Danforth**. Right.

Mr. **Pearlman**. Sure, we'll be happy to provide that for you.

Senator **Danforth**. All right.

Now, 3 or 4 years ago I got somewhat interested in subchapter C for one reason, and that is I was concerned about the craze of mergers and acquisitions that was sweeping the country, and concerned that at least in some cases the acquiring companies were not so much interested in buying, or wouldn't have been interested in buying, the acquired company but for the fact that they were picking up tax benefits. It seems to me that the tax laws should be, hopefully, neutral rather than spurring on this merger and acquisition craze.

We made some changes—didn't we—last year?

Mr. **Pearlman**. That is correct. The 1984 act does have some changes.

Senator **Danforth**. And I suppose one of the reasons for changing section 382 is, again, to try to provide fewer incentives, tax incentives, for mergers and acquisitions. Would that be right?

Mr. **Pearlman**. I think that one can look at a clear set of net operating losses as making acquisitions involving loss companies easier; but I don't want that statement to—

Senator **Danforth**. "Easier," but there wouldn't be the incentive to just go out and buy a loser.

Mr. **Pearlman**. But what I think we need to get is where you just said in your statement, and that is to make the transactions as neutral as possible.

Senator **Danforth**. Right.

Mr. **Pearlman**. So that there is no incentive to go through an acquisition.

Senator **Danforth**. But would this be a major step in that direction?

Mr. **Pearlman**. My judgment is that it would be a major step.

Senator **Danforth**. Now, let's suppose that in the tax bill that we will pass this year, or probably next year, let's suppose we want to do something on subchapter C. Would it be possible, in addition to section 382, to include anything else that would be reasonably agreed to by Treasury and the committee staffs that dealt with this problem of trying to close off the tax incentives for mergers and acquisitions?

Mr. **Pearlman**. Well, the other area is the area that the chairman and I were discussing, and that is general utilities. The general utilities doctrine is an issue that is very relevant in corporate acquisitions, and indeed has been very relevant in the designing of the acquisitions that the Congress has given some attention to over the last several years. It is probably the other issue that can be pulled out of the package and considered somewhat on its own.

I suggested before that I don't think separate consideration is compelling, but I think it is certainly possible.

I am not in a position today to tell you that it is an area where you will ultimately receive Treasury support. I did indicate earlier that I thought that the staff report went a long way toward the concerns we had expressed in connection with General Utilities earlier. I think it may likely come up in connection with fundamental tax reform; it has been suggested as an appropriate additional subject for the tax reform debate. Obviously, at some point, we are going to have to fish or cut bait; that is, take a position. And we will be prepared to do that.

Senator **Danforth**. Well, it is not necessarily the case that the administration at some point has to take positions. In the trade area, it doesn't always. [Laughter.]

But would this be worth working on, do you think? I mean, if we were just setting out a priority of things that we should be working on, 382 would be first. And would it be worthwhile, do you think, to see if we can narrow any disagreements on General Utilities and come up with a package which moves a big step toward neutrality with respect to mergers and acquisitions?

Mr. **Pearlman**. I think it is constructive to continue to look at General Utilities and try to identify the difficult issues. They are not only technical issues; there are some very difficult policy issues involved in General Utilities, and in that regard, yes, I think it is worthwhile to proceed. But I don't think any of us should understate the difficulties with an across-the-board repeal of General

Utilities. It is going to be an extremely controversial issue, and as you begin to try to address some of the areas where we have had concerns, where others perhaps will have concerns, we may end up with a very involved and complicated set of rules.

But it is an important area. And I think it is certainly one, if members of the subcommittee would want to pursue it, where we would certainly be willing to do that.

Senator DANFORTH. Thank you, Mr. Chairman.

Senator CHAFEE. Mr. Pearlman, some of the witnesses, the ABA, for example, on net operating losses, is going to suggest that the formula should be 24 percent of the purchase price for 5 years. What do you think of that?

Mr. PEARLMAN. Well, we think that rate of return is too high, and we think the period of utilization is too short. I understand arguments of the American Bar Association, and I don't want to totally dismiss them. I think that it is clear that a prospective purchaser of a loss corporation is going to give more significance, in terms of determining the purchase price, to losses that are utilizable in the first few years than losses that are utilizable in the later few years.

Senator CHAFEE. So, your same rationale, I suppose, would apply to 100 percent of the purchase price immediately.

Mr. PEARLMAN. I am not sure I understand your statement.

Senator CHAFEE. Well, instead of taking 24 percent of the purchase price over 4 or 5 years, you just take 100 percent immediately.

Mr. PEARLMAN. Yes—my same rationale.

I think that there is merit to—what the objectives should be here, I think, going back to Senator Danforth's comment about neutrality, is to try to develop rules which say that the normal income of an entity is available—its operating income is available—to offset losses. I think that is more likely to be the case if the period of the loss utilization is longer. We think the 15-year period of current law is an appropriate period of time.

There is a very strong argument that can be made that the rate-of-return calculation should use a much lower rate, lower indeed than the staff recommended; by looking rather than at rates of return on equities or rates of return on other investments, look at the historic rate of utilization of net operating losses in the economy. That would produce rates of return much less than even what the staff proposed.

I think the staff has suggested an appropriate common ground.

Senator CHAFEE. Good.

Mr. PEARLMAN. And so, I think we lean toward that approach instead.

Senator CHAFEE. OK, fine. Thank you very much, Mr. Pearlman. I appreciate your coming.

Now, the next panel is Professor Andrews, Professor Eustice, Professor Auerbach, and Mr. Kiefer.

Gentlemen, why don't you come right up. Your testimony will be restricted to 5 minutes, each.

Professor Andrews, why don't you start right off? We welcome you here, and I look forward to what you have to say.

STATEMENT OF WILLIAM D. ANDREWS, ELI GOLDSTON PROFESSOR OF LAW, HARVARD UNIVERSITY, CAMBRIDGE, MA

Professor ANDREWS. Thank you, Mr. Chairman.

My name is William Andrews. I am a teacher at the Harvard Law School, where I have taught Federal income taxation in general and taxation of corporate transactions in particular for over 20 years. I have also had the privilege of serving as the reporter on the American Law Institute study of this subject, and most recently working with the staff working group on the preparation of the present report.

I am here on my own behalf, not that of any of those groups, to affirm that I think this is a splendid proposal. I could differ—reasonable men may differ—on some details of the implementation of the proposal; and I guess I should say that I think there are problems in subchapter C with which the proposal does not deal. But the main thing is that, within the area in which the proposal would take effect, it represents a sound, fundamental, simplifying restatement of principles governing an important area of the tax law. The staff is to be commended, and I hope the committee will proceed to support and advance this legislation.

Now, what that subject is is the direct application of the income tax law to merger and acquisition transactions. And I think in evaluating the proposals one has to start by saying that the existing law on this subject is an immensely intricate and complicated outcome of a long process of more or less ad hoc response and counterresponse. A lot of the structure of the subject is still defined by very early judicial decisions, some of which were unusually harsh, like imposing a dividend tax of seven-eighths of the value of the General Motors Co. on the stockholders of that company when it was moved from New Jersey to Delaware. Other judicial decisions have been excessively lenient, like those permitting a sale of corporate assets to be exempt from corporate tax if it is preceded by a corporate liquidation. Many of those decisions were excessively formal, and have made the tax result of transactions excessively dependent upon the means by which they were carried out.

Now, the legislative responses to those decisions include the reorganization provisions, which represent a general and healthy response to some of the early harsh decisions. Those have been subject sometimes to excessively narrow construction and have themselves become excessively form-directed in their application.

The other general kind of legislative response I would mention, in a quick summary, is the kind of piecemeal response to the general utilities rule which we have seen in recent years.

And finally, in describing the present state of the law, one would have to talk about the effects on practice. It is exceedingly difficult to know just what can and cannot be done in this area under existing law, and how to do it. The result has been the emergence of an elite corps of highly skillful practitioners, and I should say the emergence of some prestigious law school courses for the education of those practitioners. Many of those practitioners, of course, are present in this room right now.

But I don't think that makes it a good result. The law sometimes produces wrong results; it often produces too much contortion and distortion. And by contortion I mean fitting corporate transactions into peculiar shapes to achieve tax results that may or may not be justified. And by distortion I mean the inducing of transactions which might not occur at all but for these tax rules.

Among other things, I think it makes it hard for this committee and the Congress to legislate accurately, or for the Government to administer these provisions accurately.

Now, what this staff proposal represents, I think, is a thoroughgoing reappraisal and restatement of this whole area of the law in terms of reflecting a direct examination of what ought to be allowed and not allowed, and an accurate and sound formulation of policy together with provisions which will make it easier for people to deal accurately with those rules and policies both in practice and on the Government side.

I guess my time is up. Thank you very much.

Senator CHAFEE. Thank you very much, Professor Andrews.

Professor Eustice.

[Professor Andrews' written testimony follows:]

STATEMENT BY WILLIAM D. ANDREWS

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

with respect to

THE SUBCHAPTER C REVISION

ACT OF 1985

SEPTEMBER 30, 1985

Mr. Chairman and Members of the Committee:

My name is William D. Andrews. I am the Eli Goldston Professor of Law at Harvard University where I have specialized in Federal Income Taxation, and particularly the income tax treatment of corporations and shareholders, for more than twenty years. I also served as the General Reporter for Subchapter C in the American Law Institute's Federal Income Tax Project, from 1974 to 1982. While both these employments are quite relevant to the subject of this hearing, my appearance today is solely on my own and not on behalf of either the Harvard Law School or the American Law Institute.

The American Law Institute (ALI) has adopted proposals for revision of the statutes governing the tax treatment of corporate acquisitions and dispositions and has published a lengthy report, in May, 1982, explaining, illustrating and commenting upon those proposals and the problems to which they are addressed. American Law Institute, Federal Income Tax Project, Subchapter C, Proposals on Corporate Acquisitions and Dispositions, and Reporter's

Study on Distributions, May 1982. As Reporter for that project I was deeply involved in the formulation of those proposals and was chiefly responsible for preparation of the report. I do not represent the ALI in my appearance today because the ALI has no procedure for taking positions on tax legislation beyond the publication of its own proposals, but my opinions are informed by lengthy immersion in the ALI work.

In its study of Subchapter C Revision the Committee Staff was directed to examine the ALI proposals, among others, and has done so with great care and critical understanding. Some of the Staff's proposals are in close agreement with those of the ALI, and others are closely related in purpose and effect.

The General Tax Treatment of Corporate Acquisitions

Both the Subchapter C Revision Act and the ALI proposals call for rather fundamental revisions in our thinking about the taxation of corporate acquisitions. The two sets of proposals differ in detail, but the important thing about them is that they affirm common general themes. In particular they both exhibit and rest upon two major general themes: (1) elimination of the distinction between reorganization and nonreorganization acquisitions, and (2) reversal of the rule in the *General Utilities* case.

1. *Elimination of the distinction between reorganization and*

nonreorganization acquisitions. Current tax law applicable to corporate acquisitions is dominated by a categorical distinction between reorganization and nonreorganization transactions, reorganizations being governed, at both corporate and shareholder levels, by a whole separate set of rules that have no application to nonreorganization acquisitions. The operative rules governing reorganization acquisitions are themselves quite sensible, but the reorganization definition, on which their application depends, is senselessly complicated. The definition is partly statutory, containing quite different technical requirements for different forms of acquisition transactions -- stock exchanges, informal asset acquisitions, statutory mergers, subsidiary acquisitions, reverse subsidiary acquisitions, and so on. Spread over all these disparate statutory requirements are some extra-statutory prerequisites set forth in judicial decisions and regulations, some of which seem to proceed from and foster an erroneous impression that reorganization characterization and treatment are a departure from some norm, to be permitted only on a strictly guarded basis.

The Subchapter C Revision Act would clear away this morass by eliminating the distinction between reorganization and purchase acquisitions as a controlling categorical dichotomy. Many of the operative rules governing the taxation of corporations in reorganizations would be preserved, but their application would be controlled by explicit elections, rather than compliance with the reorganization definition.

This elective procedure is quite akin to the procedure already adopted by the Congress in 1982, for purchased subsidiaries, in section 338. The Subchapter C Revision Act, like the ALI proposals, would extend this procedure to replace the reorganization rules as well as old section 334(b)(2). Similarly, nonrecognition treatment of shareholders, as in a reorganization, would be preserved - but on the basis of a simple appraisal for each shareholder of the effect of the acquisition on his investment viewed alone. This change would eliminate a great deal of uncertainty, complexity and injustice that results under present law from the fact that any particular shareholder's treatment may depend upon the behavior of other shareholders and whether or not it causes the whole transaction to fit within the reorganization definition, even though that behavior is beyond their control and has no significant effect on their investments. See, e.g., May B. Kass, 60 T.C.218 (1973), affirmed without opinion, 491 F.2d 749 (3d Cir. 1974).

Elimination of reorganization characterization would not involve substantial changes in what is permitted in the way of tax treatment acquisitions, but it would produce enormous simplification and clarification in how it is to be done. It would further operate to decouple questions of corporate procedure from tax treatment so that taxpayers would be spared the unproductive necessity of shaping corporate transactions in possibly inconvenient forms to produce a chosen tax result. Putting choices of tax treatment on an explicitly elective basis would also reduce the chance for parties to a transaction to defeat the revenue by taking mutually inconsistent positions, relying on different interpretations of obscure aspects of the reorganization definition, as sometimes occurs under existing law.

2. Reversal of the General Utilities Rule. In *General Utilities and Operating Company v. Helvering*, 296 U.S. 200 (1935), the Supreme Court affirmed the notion that a corporation does not realize gain on the distribution of appreciated property to its shareholders. *General Utilities* involved a dividend distribution of shares of another corporation, but the rule has been applied also to distributions in liquidation or in redemption of shares. In 1954, the rule was codified and extended to cover corporate sales of assets, if made after adoption of a plan of liquidation. Sections 311, 336, 337.

The reasons for the *General Utilities* rule are obscure; the Supreme Court itself simply took the general rule for granted without explanation. Perhaps the rule derives in part from a naively literal application of the idea that a corporation is a legal person, to be treated as if it were a natural person: a natural person does not realize gain by giving away appreciated property to the objects of his affection, and so neither should a corporation realize gain by distributing appreciated property to its shareholders.

But whatever the reason for the *General Utilities* rule, it has proved in practice to be a great and continuing source of mischief and controversy. The basic trouble is that the rule permits (invites and induces) the arrangement of transactions, particularly acquisition transactions, to produce a step-up in the basis of corporate assets without any corresponding corporate tax. Since the result of stepping up basis is to produce exclusions or deductions from taxable income in the hands of the transferee, the net result is uncompensated erosion in the corporate income tax base, together with all the distortions of behavior any such erosion is apt to produce.

The Congress has already responded to exploitation of the _General Utilities_ rule by repealing it piecemeal in many situations. As to depreciable property, we have depreciation recapture, which cuts across the _General Utilities_ exclusion. Other special statutory rules apply to installment obligations and to LIFO inventory. Nonstatutory exceptions have been hammered out in litigation covering earned but uncollected income items and recovery of previously deducted items other than depreciation. Moreover, the provisions of subchapter C itself have been repeatedly amended in recent years to narrow the scope of the _General Utilities_ rule, so that it is now largely inapplicable except to complete liquidation distributions.

In addition to all these various direct exceptions, there has been a different kind of special response to some corporations formed or utilized with a view toward exploiting the _General Utilities_ rule. Such corporations are labelled collapsible corporations. Under some circumstances the consequence of that labelling is imposition of corporate tax that would otherwise be forgiven under the terms of section 337; under other circumstances the consequence is recharacterization of shareholder gains as ordinary income instead of capital gain. Presumably because of the potentially drastic harshness of this latter response, the collapsible corporation provision is fitted out with a series of exceptions and limitations, which often operate to give well-advised taxpayers effective ways to avoid its application altogether.

The Subchapter C Revision Act would eliminate all these problems by repealing the General Utilities rule itself, substituting the simple, measured general rule that a corporation must recognize gain on any disposition of appreciated property except one in which basis carries over to a corporate transferee. This reformulation would produce enormous simplification, superseding the present piecemeal exceptions to the General Utilities rule and making it possible to repeal the collapsible corporation provision. Beyond simplification, this change would produce a much more even-handed application of the income tax and would ameliorate the unproductive bias of current law in favor of corporate acquisitions shaped to take advantage of the exclusion.

The Revision Act would effectively except goodwill and other unamortizable intangibles from the repeal of General Utilities, since a step-up in basis of such tangibles will not reduce subsequent taxable income. Moreover, the Act contains a special credit for shareholders of acquired corporations designed to provide relief from concurrent imposition of corporate and shareholder capital gain taxes. The ALI proposals also include such a credit, but the Revision Act proposal is somewhat different. The provision in the Revision Act would be fully applicable only to corporations with a fair market value of $1,000,000 or less, and partially applicable to other corporations worth less than $2,000,000. Furthermore, the Revision Act credit would take the form of a basis adjustment instead of a credit against tax in the strict sense. Both these differences from the ALI proposal seem to be useful and appropriate improvements.

3. Differences and Similarities between the Subchapter C Revision Act and the ALI Proposals. There are a number of differences in detail between the Revision Act and the ALI proposals. The ALI proposals prohibit simultaneous cost-basis and carryover-basis transfers between any particular corporate groups; the Subchapter C Revision Act, reflecting difficulties experienced with section 338, sets forth a more specific but lenient rule requiring consistency only on an entity-by-entity basis. As mentioned before, the proposed Subchapter C Revision Act has a more refined proposal for relief from the concurrent burden of shareholder and corporate taxes in the case of small corporations. The Revision Act also has a useful nonrecognition provision for liquidating distributions in kind - a broadening of present section 333. The ALI proposals have a rather extended discussion of the rather esoteric subject of purchase premium in a carryover-basis acquisition; the Revision Act contains a

relatively straightforward three-year rule for disposing of that problem.

None of these differences go to the root of either the Revision Act or the ALI proposals. The important thing about the Revision Act and the ALI proposals is not their differences in emphasis or detail but their agreement on common themes. The differences tend to confirm, indeed, the fact that the common themes have survived the test of examination and elaboration by two quite independent working groups. From the Committee's standpoint, the ALI proposals should stand primarily as independent confirmation that abandoning the reorganization definition and overruling General Utilities will indeed lead in the direction of simplification and clarification and will not prove in practice to have unanticipated complicating implications.

ALI consideration of its proposals is no substitute, of course, for consideration by other interested groups as well. But still, the ALI procedure is one of lengthy deliberation by distinguished expert panels. The Reporter in the ALI project was closely guided from the beginning by about a dozen consultants who met typically two or three times a year for two or three days each time, to assist, advise, question and criticize in the early stages of formulation of the proposals. The consultants are listed in the front of the ALI Report; I cannot imagine that a more distinguished, diligent, or intelligent group of tax law practitioners (and teachers) could be assembled. Tentative drafts were subsequently distributed to and considered by the Tax

Advisory Group, a larger panel of leading tax lawyers from around the country, also listed in the front of the report. This group met several times for several days each time. Drafts were then discussed and finally approved by the Council of the Institute and the membership in annual meeting assembled. Both the consultant and advisory group meetings were attended also by a liaison committee from the Tax Section of the American Bar Association and by personnel from the Treasury Department and Congressional Committee staffs. Moreover, the ALI work, together with the Staff's prior preliminary proposals, have now been the subject of professional conferences and critical scholarly appraisal in various journals.

The relation of the ALI work to the proposed Revision Act is twofold. It stands as a source of argumentation and elaboration -- in some cases along alternative lines -- of the main themes in that Act. But also it stands as affirmation from a significant quarter in the practicing bar of the practical workability of these main themes. I hope the Committee will find that the ALI work helps it to conclude that the Subchapter C Revision Act is indeed sound and promising and deserving of prompt attention, support and enactment.

Special Limitations on Loss Carryovers

The final sections of the Subchapter C Revision Act would substantially amend the present provisions limiting loss carryovers following corporate mergers and acquisitions. These limitations were also the subject of protracted study and extensive proposals by the ALI. Special attention to these limitations, in both studies, is partly due to the special situation surrounding section 382, with amendments adopted in 1976 whose effective date has been repeatedly postponed; these amendments are currently scheduled to go into effect next year.

The principal defect in the present limitations on loss carryovers, including the 1976 amendments, is that they do not distinguish in any automatic way between losses that are merely incidental to a substantial business transfer and losses that are so large, relatively, as to be the main object of transfer. Section 269 of the present code applies only to acquisitions whose principal purpose is avoidance or evasion of taxes, but this condition is an unsatisfactory one to administer, for taxpayers and government alike. What is needed is a relatively objective formula provision, like the present section 382, but with a formula that will operate to allow incidental carryovers while limiting or disallowing carryovers that are unusually large in relation to the value of the business or investment assets to which they are attached.

Ideally a loss carryover should be freely transferable and fully utilizable after a corporate acquisition to the extent it would likely have been usable by the loss corporation if no acquisition had occurred; otherwise the tax provisions will be an unnecessary deterrent to economically desirable acquisition transactions. On the other hand, if one does not wish to have corporate acquisition transactions driven by tax advantages, then loss carryovers should not be allowed to an extent that would make the carryover worth substantially more after an acquisition than if no acquisition had occurred. The objective should be one of neutrality in which a change of ownership or combination affecting a loss corporation will neither enhance nor impair the value of its carryovers.

The Subchapter C Revision Act would amend section 382 in a manner that has just these desirable effects. In place of the disallowance rules in present law the Revision Act has a limitation rule, limiting the availability of acquired loss carryovers to an amount equal to the applicable Federal long-term interest rate applied to the total value of the loss corporation at the time of acquisition, generally as reflected in the price paid for it in the acquisition. In the case of a carryover that is relatively small in relation to total value this limitation will tend to allow full and prompt utilization of the carryover, while severely restricting the deductibility of carryovers that are large in relation to total value; and this differentiation is achieved without resort to findings about taxpayers' purposes in carrying out a particular transaction. This provision represents a substantial improvement over present law and deserves prompt and favorable attention and enactment.

The provision in the Revision Act is substantially the same as one branch of the rule in the ALI proposals on this subject, the so-called purchase rule. But the ALI proposals have another rule for mergers and combinations, which are defined to include acquisitions for stock of the acquiring corporation. The merger rule is similar in general import to the purchase rule, but contains a different rule of measurement of the limitation: the ALI merger rule allows premerger losses only to the extent of a share of post-merger earnings corresponding to the loss corporation shareholders' share of the stock of the surviving corporation resulting from the merger. If, for example, the loss corporation shareholders get 5 percent of the stock of an acquiring coporation in a merger, then its loss carryovers from pre-merger years will be allowed as a deduction against post-merger income only to the extent of 5 percent of the total earnings of the merged corporation.

The merger rule has been omitted from the Revision Act primarily because it is perceived as complicated to explain and to implement, and because the interrelation of merger and purchase rules, in particular, is perceived as confusing.

In appraising the omission of the merger rule, one should distinguish between its application to transactions that constitute acquisitions of a loss corporation and its application to other transactions which do not involve any such acquisition. With respect to the former, the question is indeed whether there should be two rules or one, and all other things being equal one rule is doubtless better than one. But in some particular situations the merger rule might indeed be simpler in application, or less arbitrary than the purchase rule; it would not depend upon either a valuation of the acquired enterprise or the determination of a suitable imputation rate to be applied to that value. These advantages, even if real, may well seem insufficient to justify the complications that arise from having two rules instead of one.

But the much more important question has to do with transactions that do not involve acquisition of a loss corporation at all. Consider a large corporation that has gone out of business but has a large tax loss carryover. One way to exploit that carryover is by acquiring profitable corporations in merger transactions. The effect of these mergers is to expand the pool of corporate capital against whose earnings the carryovers can be deducted, and thus to enhance the value of the loss carryovers; and the prospect of such enhancement has therefore functioned as an inducement to keeping loss corporations alive and conducting merger transactions that otherwise might well not have occurred. Section 382 would not apply to limit the deductiblity of carryovers in this transaction, in either its present-law form or as proposed to be amended in the Revision Act. The ALI merger rule would apply, however, on the general theory that there is just as much reason to be concerned about tax motivations distorting economic decisions in the acquisition of profit corporations by loss corporations as in the contrary case. (Some might even argue that there is more reason to be concerned since a transfer of control from successful operators into the hands of proven losers is presumably less desirable than a transfer of control of an unsuccessful corporation.)

The main reason for having the merger rule is to reach cases that do not involve any acquisition (however defined) of the loss corporation in a merger or combination transaction. If one has the merger rule, then it seems most natural to let it apply also to mergers that do involve an acquisition of the loss corporation. It would be possible, however, if one wanted to have only a single rule for acquisitions, to make the purchase rule applicable to all acquisitions of loss corporations, whatever the consideration, and then also adopt the merger limitation but only for mergers that do not involve acquisition of a loss corporation.

In my view the Revision Act would be even better than it is if it contained a merger limitation in addition to its purchase limitation. But no general consensus has emerged in support of that view, and the purchase rule alone, as set forth in the Revision Act, would represent an enormous improvement over existing law. I would therefore urge that it be adopted now, with the possibility of adopting a merger rule too, to reach nonacquisition merger transactions, left for further study and future action if and when that is deemed desirable.

Timing and Priorities

These are very busy times for this Committee and for other people concerned with issues of tax policy. On the one hand, the President has issued a call for comprehensive reexamination and sweeping revision of the income tax. Evaluation of the President's proposals is obviously a matter of urgent, immediate concern. On the other hand there have been a series of very particular legislative enactments, dealing with a variety of quite specific abuses that have emerged in practice under the existing law - firefighting enactments, as it were. These too are matters of immediate concern, requiring prompt action as soon as the opportunities for abuse with which they deal become apparent. Some of the Staff proposals in its preliminary report on Subchapter C, of September 22, 1983, fell in this category, and some of them have already found their way into the law in the Tax Reform Act of 1984.

The Subchapter C Revision Act is in something of an intermediate category. It involves fundamental revision of the law in a special but very important area. It is not an emergency response to things perceived as immediately pressing abuses, but it would eliminate a variety of important, chronic abuses and create an environment in which acute abuses are less likely to emerge as time goes by. For the long-term health and simplification of the system it is vitally important that legislation of this kind be developed, supported and enacted.

This kind of legislation need not be enacted in haste. It deserves and needs and can afford extended study. But that condition has been met. The Subchapter C Revision Act itself was published in May of this year, but the proposals it embodies have been the subject of intense study, and general approval, in a variety of forums over an extended period of time.

There is a risk that legislation of this kind will fall between the boards, as attention is devoted to what seem more pressing matters. But it would be a great mistake, in my view, to let that happen. The Committee Staff, with help from a wide variety of other sectors, has brought this legislation to a point of development where it ought not to be left to languish. Substantial improvements on the present draft are not likely and not worth waiting for. I earnestly hope that the Committee will make the time to bring this statute forward reasonably promptly for consideration and enactment.

Conclusion

For all these reasons I earnestly urge that the Committee take up and report favorably on the Subchapter C Revision Act, substantially as presented in the Staff Report.

Thank you.

STATEMENT OF JAMES S. EUSTICE, PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, NY

Professor Eustice. Mr. Chairman, my name is James Eustice. I am a professor at New York University School of Law. I, too, appear on my own behalf as a specialist, if you will, in the area of subchapter C.

I read the other week that the President said that the main thing about the present tax law is that it is a boon for tax lawyers and a drag on just about everybody else. I would beg to disagree with that conclusion.

Senator Chafee. Maybe that is a fair equation.

Professor Eustice. Most of us in this room would think it is pretty much of a drag on the tax lawyers as well. Certainly, it has been for me. I have the feeling that there is a tax bill out there somewhere with my number on it; one that is going to catch me before I am too young to quit and too old to learn.

This, however, is not one of those bills. I think it goes a giant step forward in creating reasonable order out of what, while fun to teach, can only be described as definitional chaos. I don't think even the Secretary would disagree that the definitional change of what constitutes an acquisition would be a major step forward. If nothing else came of it, we would get rid of the present alphabet soup of acquisitive transactions in which we now have at least 14 different types of acquisitions, all with their own set of rules, which is absurd. That alone would be worth the effort.

I think the other features of the bill are equally sound. This is not something that has jumped off somebody's table; people have been working on this for a substantial period of time.

The key to the proposal, I think, is a sound one. Its essence depends on what happens to asset basis. If the parties want to keep asset basis at historical cost, then nothing will happen at the corporate level. If they choose to engage in a transaction with a step-up in basis, then the tax toll will have to be paid. In other words, the repeal of General Utilities in this context is an essential ingredient. The key proposal here is electivity as to basis treatment. Today this is essentially what happens, but you have to go through this incredible minuet of transactional selectivity in order to find the right letter of the alphabet to get the desired tax results.

I think if we could slice through this particular facet of the tax law, it would be a major step forward, at least in my life and I believe the lives of most people in this room.

When we come, however, to General Utilities on the other side of the coin, not in the acquisition context but in the case of a straight liquidation, I think we begin to get a little more controversial. I am sure we will hear much today about "mom and pop" and the long-held businesses that were built up over 25 years. "You can't do that to us." I have a terrible feeling, though, that if you put aside the relief proposal which the staff suggests, which I think is eminently suitable to "mom and pop," what you really have out there is "Dynasty" waiting to use General Utilities in the way it has been used. And whether you want to draw the line between "large" and "small" is not the important point; I think the line has to be drawn. The staff's line, which is based on a small-business shareholder-level credit form of relief, is certainly not an unreasonable line to draw here.

Clearly, the provisions cannot be allowed to have corporate nonrecognition and a basis step-up if you want to have neutrality in the corporate-acquisition area.

I have a little less enthusiasm for the staff's net operating loss proposals. I tend to come down on the side of the ABA version, mainly because they are simpler. We could quibble over the recovery rate; I am not sold one way or the other on the ABA rate. But, essentially, both proposals deal with the same basic problems and have the same basic theme; that there should be neutrality in the passage of these corporate tax attributes from one corporation to another. And they are not that far apart.

I think the rate is not unreasonable. This is a risk-free rate and I think deserves to be a little lower.

On the whole, I strongly support virtually all of the staff's proposals.

Thank you.

Senator CHAFEE. Thank you very much, Professor Eustice.

Professer Auerbach.

[Professor Eustice's written testimony follows:]

TESTIMONY OF JAMES S. EUSTICE

INTRODUCTION AND SUMMARY OF CONCLUSIONS

My name is James S. Eustice, and I am a professor of law at New York University School of Law. For over twenty years I have devoted my scholarly and professional activities to the study and interpretation of Subchapter C. I am the coauthor, with Boris I. Bittker, of a treatise on corporate taxation and also have written numerous articles on corporate tax subjects. I was a member of the "working group" which consulted with the Finance Committee Staff during the course of its deliberations on the subchapter C project.

Recent legislative events have filled me with a sense of foreboding that there's a tax reform bill our there somewhere with my number on it—one that will catch me when I'm too young to retire and too old to learn; this may be that bill. But despite a strong temptation to describe the present Subchapter C rules as "perfect", conscience compels me to conclude that they are far from that. The Staff's proposed revision of Subchapter C also is not a "perfect" solution to what ails this area of the law (assuming one could ever agree as to what "perfect" would mean in this context), but it is, in my opinion, a far better world than what we have now. Moreover, it is enough of an improvement over existing law to justify a change—which in my book is a rather heavy burden of proof to satisfy.

In summary, my comments on the Staff's proposed revision of Subchapter C as submitted in its final report of May 1985, are as follows:

1. *Corporate-level electivity.* Adoption of an explicitly elective system governing the corporate-level tax consequences of a "qualified acquisition", and adoption of a uniform definitional structure for "qualified acquisitions", creates a significantly superior regime to the transactional electivity and definitional chaos that exists under current law. The Staff proposal is far simpler, fairer, and considerably more rational than existing law, which places an unduly heavy premium on sophisticated tax advice, contains numerous traps for the unwary and, as a practical matter, is essentially elective in its own right through the mere selection of a particular transactional mode. There are at least ten forms of tax-free acquisitive reorganization currently available under existing section 368 (and arguably even more if insolvency acquisitions and section 351 are added to the menu), each of which have different definitional requirements. Surely, if nothing else comes of this legislation, elimination of present law's excessive and irrational definitional minutiae would alone be worth the effort.
2. *Shareholder-level treatment.* Separation of shareholder-level tax consequences from the corporate-level tax results and from the tax consequences to other shareholders also is a significant improvement over existing law. There has never been

any compelling reason to link the tax treatment of shareholders in a corporate acquisition to what happens at the corporate level. Nor, for that matter, has it ever been clear to me why the type of consideration that one shareholder receives in an acquisition should dictate the tax consequences to other shareholders in that transaction. The Staff's proposal, which provides generally that those shareholders who get stock of a party to a qualified acquisition will receive tax-free exchange treatment, regardless of what elections are made at the corporate level and irrespective of what other shareholders receive in the acquisition, would eliminate unnecessary technical traps that exist under current law and obviate the need for the parties to engage in elaborate formalisms to achieve their desired tax results.

The Staff's proposed revision of the "boot" rules in section 356 is also a major improvement over present law. These changes have been urged, in one form or another, for nearly three decades, starting with the Advisory Group proposals in 1957 and 1958. The boot rules of present law frequently lead to irrational and unintended results, depending upon a variety of factors unrelated to the basic transaction at hand (e.g., the shareholder's stock basis and the extent of corporate earnings and profits), and contain considerable potential for abuse. Moreover, the numerous interpretative uncertainties surrounding present section 356 (i.e., how does one test for "dividend equivalence") offer another compelling reason to support the Staff's proposed amendments. One does not have to agree with every technical position contained in these proposals, as I do not, to conclude nevertheless that they would constitute improvement over the current rules.

3. *Definitional structure.* The decision of the Staff proposals to continue use of the same section numbers as current law is heartily appreciated by this observer and, I would expect, virtually all of the tax bar. I would, however, go even further by shifting the acquisition definition rules of proposed sections 364–366 to old familiar section 368 (for the author's attempt at this exercise, see Appendix A). There have been enough changes in the tax law of late without having to deal with new section numbers in the bargain (this was my principal irritation with the Subchapter S Revision Act of 1982, an otherwise generally laudable legislative effort). I do, however, have several technical quibbles with portions of the Staff's definitional proposals which are reflected in the second part of this written testimony.

4. *Complete repeal of General Utilities doctrine.* The proposed "almost-complete" repeal of the General Utilities doctrine, while considerably more controversial, nevertheless is probably a necessary corollary to the basic acquisition proposal since the "toll charge" required for elective cost basis treatment by the acquiring corporation is current recognition of gain or loss by the target corporation; a carryover basis election, by contrast, generally will not result in gain recognition to the target corporation. If the General Utilities doctrine is retained in this context (i.e., the present law nonrecognition system of sections 336, 337 and 338) a fundamental premise of the Staff's acquisition proposal would be undermined, since the essence of that regime is that corporate assets will be allowed to move tax-free from one corporation to another only if their historic tax basis is preserved. Allowing nonrecognition on the target side and a basis step-up for the buyer would perpetuate the discontinuities of present law. In other words, acceptance of the Staff's basic acquisition proposal of necessity seems to require at least a partial repeal of the General Utilities doctrine in the case of qualified acquisitions where cost basis treatment is elected.

The General Utilities doctrine has been effectively repealed, for all practical purposes, in the case of nonliquidating distributions; the few exceptions still remaining after the 1984 Reform Act are extremely narrow in scope. In fact, the 1984 Act amendments went considerably beyond the Staff's preliminary proposals in 1983, and totally eliminated the exception for inter-corporate distributions of appreciated property, even where the parties are "affiliated" and file a consolidated return and even though these distributions do not result in a basis step-up to the distributee.

In my opinion, the 1984 Act went too far in this respect. The reasons cited in the 1984 legislative history as justification for taxing gain to the distributing corporation on distributions to corporate shareholders do not seem to justify so sweeping a change. Since the basic premise for repeal of General Utilities is that gain should be taxes to the corporate transferor whenever a transferee of that property obtains a new stepped-up basis, inter-corporate dividends in kind do not present an appropriate case for triggering current gain (especially in the case of affiliated corporations that file a consolidated return). The Staff's final report does not recommend a return to the approach of its preliminary 1983 proposals. In this respect I believe it is deficient and it is certainly inconsistent with the basic thrust of the acquisition proposals that corporate level gain recognition is keyed to a transferee's basis step-up.

This same reasoning also applies to distributions of various recapture properties, although here (improperly so in my view) recapture gain also is triggered by a dividend in kind. Moreover, present law now distinguishes sharply between potential gain and potential loss property; the former is taxable when distributed, but the latter is not (even though basis is stepped-down). While losses can always be recognized by making the sale to a third party (and even to a shareholder if section 267 is not violated), I fail to see why a distribution in kind should not also trigger current loss recognition (subject to section 267). Finally, the potential application of section 311 to distributions of stock of controlled subsidiaries places an inordinate burden on qualifying that distribution under section 355, since that is the principal exception to application of the gain recognition rule under both the 1984 Act and 1985 Staff proposal. Certainly, in the case of corporate parent distributees, section 355 is of concern only to the distributing corporation, which is an unsatisfactory state of affairs and an undue burden for section 355 to carry.

Complete liquidation distributions (and corporate sales that do not constitute a "qualified acquisition") will result in taxable gain or loss under the Staff proposal (with two alternative forms of special relief in the case of liquidating forms of special relief in the case of liquidating distributions, both of which operate at the shareholder level). On balance, I generally support the Staff's approach, but would prefer to see a shorter capital asset holding period than five years (three seems more than enough and even the long-term capital gain line would not particularly bother me). I'm not totally convinced that this relief necessarily must be limited to "small business" liquidations, but, as a practical matter, these are the transactions that most likely would be adversely affected in any meaningful way be a total repeal of sections 336 and 337. Designing a reasonably workable shareholder level relief provision for the rare large corporate liquidation probably in not worth the effort.

5. *Loss carryover limitations.* As to the Staff's loss carryover proposals (another controversial area), they are probably preferable to the current law rules, the principal virtue of which is their age and generally understood interpretations. The Staff's proposals are, however, clearly superior to the 1976 amendments, and the final report's adoption of a single limitation based on acquisition value also is preferable to the "two-rule" approach suggested in its initial 1983 preliminary report. As a result, I could generally support the basic approach to loss carryover limitations adopted in the Staff's final report. The "neutrality principle," which is the foundation for this proposal (and for that of the ABA Tax Section version as well) seems to me to be a reasonable compromise on how ultimately to proceed in this area, where there may be no "right answers," but there are certainly better answers. It is definitely simpler and more rational than present law, although I personally feel that the ABA Tax Section proposal is the simpler of the two.

The rate of loss carryover consumption proposed by the Staff, based on the applicable long-term Federal rate, seems to me, however, to be on the low side; I would personally prefer the ABA Tax Section proposals for a five year earn-out system. I even have some mild preference for an immediate utilization formula, but that is probably too much to hope for at this point.

The Staff proposal also arguably seems deficient in the treatment of target company debt, which is excluded from the computation of the acquisition price limitation. Thus, highly leveraged loss companies will not be able to shift much in the way of their loss history to new purchasers under the Staff proposal (nor, for that matter, under the ABA proposal either, if the debt remains outstanding).

On the other hand, if the loss company is involved in a title 11 proceeding, creditor takeovers will not even trigger application of the loss limitations. This provision may be overly generous; it certainly places inordinate weight on how "sick" the loss company really is, what formal proceedings it is using to restructure its operations, and who ends up taking over ultimate control of the company. The ABA proposal provides for a reasonable compromise on these questions, viz., if aged debt (two years old) is capitalized (either before or after the acquisition), it will increase acquisition value, and hence the amount of the gross carryover limitation. In any event, the Staff's treatment of preferred stock as "quasi-debt" (i.e., it counts in determining the acquisition value limitation, but is ignored in determining whether a control shift has occurred), adds a further discontinuity to this situation.

Finally, while I, like most of the tax bar, would dearly love to see the demise of section 269, it is probably folly to totally terminate this provision, since I am not able to devise a system that can anticipate every potentially abusive transaction. In fact, I would even suggest that the Staff's section 382 proposal is located in the wrong venue; it does not belong in Subchapter C at all, since its function is to limit deductions and credits allowable under other Code provisions. Perhaps these proposed rules could be shifted to the disallowance portion of the Code, and they could even replace section 269 itself. I also think these rules can be encompassed in a single Code section, rather than three, with a little effort. In fact, a redraft of section 269 is not impossible and could easily reflect most of what is contained in the currently proposed version. I would, however, retain a "germ" of old section 269 by giving authority to challenge any transaction where tax avoidance is the principal motivating purpose, with either partial or total disallowance of the sought after tax benefits. This rule would not operate in the garden variety acquisition transaction because of the neutrality principle, but it would catch transactions that we haven't been able to envision yet; the British have such a rule, and it might be the "star wars" defense system in the tax shelter struggle.

The Staff's proposals would, I believe, permit elimination of the SRLY limitations in the consolidated return regulations; these proposals are, in effect, a modified codification of that system. I would not, however, extend the built-in loss limitation to built-in depreciation deductions (which the SRLY rules do), since that would, in effect, give an immediate stepped-down basis for all high basis assets and violate the basic premise of the acquisition rule system. If some limitation is thought to be necessary here, perhaps the SRLY limitation is thought to be necessary here, perhaps the SRLY limitations could be retained solely for the purposes of depreciation deductions and the like. I share the view of the ABA Tax Section that no special "investment company" rule is necessary here; a loss is a loss, and the neutrality principle will not let it be negotiated in an uneconomic transaction. Moreover, the additional complexity created by trying to draw lines between "business" and "investment" simply isn't worth the effort and the consequent uncertainty spawned by the attempt.

In conclusion, I would prefer to see the adoption of the ABA Tax Section loss limitation rules, but could also accept the Staff's proposals as a respectable alternative.

6. *General observations and conclusion.* On the whole, I can support both the general approach of the Staff's final Subchapter C proposals and most of the details as well. My strongest endorsement is with respect to the acquisition proposals which would, in my opinion, constitute a major improvement over current law. General Utilities' repeal is a key ingredient of those proposals, and the relief rules suggested, though certainly not overly generous, should be adequate to cover most cases of genuine hardship. The loss carryover limitation proposals are less endearing. I personally favor the ABA Tax Section approach, which is considerably less complex without opening any barn doors for potential abuse.

If there is any fault in the Staff's final proposals, it is a seeming paranoia that somewhere, somehow, a dollar of tax might be saved through some ingeniously contrived transaction. That theme has totally dominated recent tax legislation during this decade (e.g., the 1981, 1982 and 1984 Acts evidence an increasing level of hysteria on this score), and is largely responsible for the increasing level of tortuous complexity that has enveloped the Code today. For my part, I would let a few miscreants slip through the net if the system could be significantly simplified for the many. It strikes me as somewhat ironic that the 1983 preliminary Staff report was entitled "Reform And Simplification" of Subchapter C, while the present report is simply "The Subchapter C Revision Act"; in other words, the current model is different, but it isn't simple. It could probably be made much simpler, especially in the loss limitation section, by accepting a basic premise that not every corporate-shareholder transaction has a lurking tax avoidance abuse potential—some do, but many, if not most, don't in my experience.

Finally, I heartily applaud the Staff proposal's restrained resort to the device of regulation delegations; over use of this technique in recent legislation is threatening to engulf the tax bar in a tidal wave of administrative confusion and uncertainty. I would even go so far as to suggest that the effective date of these proposals could be delayed for three years in order to give the Treasury ample time to draft regulations under these provisions. Such a delayed effective date approach might also permit elimination of any *General Utilities* relief rule, which would further simplify these proposals.

TECHNICAL COMMENTS

The acquisition proposals

1. *Definition of "qualified acquisition".* In view of the rigid 70/90 test adopted for effecting a qualified asset acquisition, I believe that a special provision will be necessary to deal with the Type "G" reorganization of current law (i.e., "insolvency" reorganizations). If a corporation is truely insolvent, its "net assets" are zero, and thus it will not technically be possible to have a qualified asset acquisition in this situation. Perhaps the more flexible "substantially all" standard applicable to related

party acquisitions could be applied here as well; even better is the language of the current Type "G" provision itself, "all or part of its assets" (the general effect of this rule is to permit both acquisitive and divisive transactions in an insolvency reorganization). The insolvency reorganization provisions took over a decade to get enacted in the recent 1980 Bankruptcy Tax Act; Scrapping them after five years for the unknown is probably not a wise idea.

The mandatory liquidation requirement for a qualified asset acquisition allows 12 months from the acquisition date (the analogue of present law's section 337); after the 1984 Tax Reform Act, however, the target in a Type "C" reorganization must liquidate "pursuant to the plan of reorganization" under section 368(a)(2)(G), which is a tighter nexus to the overall acquisition transaction. Of the two approaches, it seems to me that the latter is more appropriate (and also provides less room for manipulation by the target corporation) than a 12-month period. In any event, reincorporation of the distributed assets should not vitiate the complete liquidation requirement; perhaps even a special elective "deemed liquidation" rule could be added here (on the order of the current law Type "C" reorganization rule added by the 1984 Act).

Is section 364(c)(3) designed to perpetuate the Bausch & Lomb limitation? For example, if target is a 31 percent owned subsidiary of the acquiring corporation, this provision would prevent a qualified asset acquisition, since neither 70 nor 90 percent of the subsidiary's assets would be acquired in a qualified transaction; this also would be the case with even an 11 percent subsidiary, since the parent could only obtain 89 percent of its net assets by qualified acquisition, the rest being obtained by a "distribution". If this result is intended (mayble it isn't, but it certainly looks that way), then it seems to me to be an unnecessary tightening of existing law with no particular benefit to the integrity of the Staff's acquisition system. In any event, this question certainly should be highlighted, one way or the other, in the Technical Explanation. Since Bausch & Lomb is generally thought to be part of the continuity of interest limitation, I see no reason to perpetuate the principle of that decision in the proposed new acquisition system, especially in view of the Staff's avowed purpose to repeal the continuity of interest principles of current law.

Finally, though this is only a matter of form, I believe that it is form with considerable substance, viz., the definition rules of proposed sections 364–366 easily could have been placed in section 368. I can think of no reason why this shouldn't be done and several why it should. First, many of the acquisition definitions contain concepts that are directly traceable to present section 368 provisions (e.g., "substantially all", "control", "party to the acquisition", etc.). To the extent familiarity can be preserved through the use of the same section numbers (as it has in most of the Staff's other proposals), this is to me a very salutory thing, especially for harried practitioners. The argument that new sections are needed to demonstrate that something different has occurred, does not move me. Second, section 367 doesn't belong in this part of the Code in any event, since it is an operative rule, not a mere definition rule. I would keep section 367 where it is (out of a decent respect for historical precedent), but, for the same reason, I would keep the definition sections in section 368—that's where people expect to find them and I see no reason to "hide-the-ball". Finally, three sections are not necessary to do the definitional job here, especially where one is up to the task. For a sample attempt, see Appendix A.

2. *Corporate-level treatment; electivity.* Asset acquisitions receive mandatory carryover basis treatment if they occur between related corporate parties (i.e., the section 304(c) control line). The proposed statute could be shortened by adopting the 1984 Act approach in section 368(c)(2), i.e., by incorporating section 304(c) by reference. Cost basis electrivity also has been denied for "recapitalizations" and "reincorporations"; conversely, cost basis treatment is mandatory if assets move from a regular "C" corporation to a tax-exempt, foreign, or requlated investment company. Consistency is required for assets on an entity-by-entity basis, though not on a group-wide basis as under current law, but an exception is provided for "goodwill" and the like, as to which a separate carryover basis election can be made. In short, wholesale electivity is clearly not present under the proposals, nor is consistency as rigorous as current law. In fact, with pretailoring permitted, the accidental fact that assets are held as a division instead of in a subsidiary takes on considerable significance, since, in the former case, the consistency rules will apply, while in the latter they will not. This is not a readily defensible state of affairs.

I, for one, would allow total electivity, without any consistency limitations, so long as assets are still in corporate solution, since the essence of the Staff's acquisition proposal is that basis step-ups must exact a corporate-level toll charge. In other words, if the parties want to step-up basis, then gain will be recognized and tax paid; if they don't, then no gain will be recognized at the corporate-level, but will be at the shareholder-level if boot is involved. Carving out exceptions to this regime for "related parties", goodwill, inconsistent acquisitions of assets, etc., will surely lead us back into the mess we now occupy under section 338, all for little in the way of abuse prevention. The consistency rules were adopted in 1982 because of General Utilities; with the repeal of the latter, the need for these limitations no longer exists.

Bail-outs can be adequately defended against under both present law and by the rest of the Staff's proposals. Moreover, a great leap forward would result if corporate shareholders were completely removed from the regime of section 304; they cause only mischief under that provision, and their presence is totally unnecessary to the mission of that section. If a related-party asset or stock acquisition has the effect of a dividend, the Staff's proposals will treat it as such (as does current law after 1984); denial of a basis step-up seems unnecessary, especially when corporate-level tax will have to be paid to obtain that step-up. In fact, I see no good reason why we simply could not allow a corporate "election" to step-up the basis of any, or all, of its assets if taxable gain results therefrom; the presence of a qualified acquisition (or of any acquisition for that matter) does not necessarily have to be a condition for this result.

If, however, the Staff's proposed regime must be retained, then it seems logical to me that asset transfers to "S" corporations ought to be added to the mandatory cost basis list in section 365(f) since the end result is the same as an asset transfer to a tax-exempt, etc., organization, viz., the asset leaves the corporate tax system. Mere conversion from a C to an S corporation, however, need not be covered here; the Staff proposals do deal with that situation in a generally acceptable manner by denying a shareholder-level basis step-up for the gain subsequently realized by the S corporation. In short, I would impose section 365(f) treatment on an asset transfer *to* an S corporation, and leave proposed section 1367(c) to apply solely for C to S election situations.

3. *Shareholder-level treatment.* (a) "Party" stock rules: The definition of "qualified consideration" is tied to stock of a "party to the acquisition", and the proposal, in section 366(d), generally delegates to regulations selection of those affiliates in the acquiring group who will be appropriate party "quests". I would have expected that here at last was the occasion to rid the Code once and for all of any lingering remnants of the Groman-Bashford doctrine and its uncertain radiations, which have probably done more than any single court decision to complicate and confuse section 368. The Staff's Technical Explanation, however, invites the regulations to perpetuate a direct 80 percent chain linkage to the acquiring corporation in order to qualify as "party" stock; if we are abolishing continuity of interest generally, let us do so all the way, and certainly here. I can think of no persuasive reason why stock of any member of an acquiring affiliated group should not constitute qualified consideration stock. I note, however, that one aspect of the Groman "remoteness" problem has been cured under the proposed amendment to section 1032, a long overdue provision. I would emphatically hope that the job of repealing Groman finally could be finished.

In this same vein, I am saddened to see that the Groman "remoteness" concept continues to apply on the acquired corporate side of the transaction as well, since only stock of the target can be exchanged tax-free under section 354(a). The effect of this limitation is that tax-free acquisitions of subsidiaries of the target are only entitled to nonrecognition treatment at one level, i.e., tax-free treatment is tied solely to the acquired subsidiary's stock, which is the case under current law. This result seems to me to put an unnecessary premium on the happenstance of corporate structure. I would propose that the stock received in the acquisition at least should be purged of any gain potential, which is the Staff's proposed general rule, but which rule does not apply in the instant case as noted subsequently. A partial cure is provided in section 354(c), but this provision does not go far enough in my view since it only applies to cases where all of the parent's assets are acquired in the transaction, and furthermore only extends to one level in a chain of corporations. I would go all the way here and allow nonrecognition treatment at all levels where stock of the acquiring party is the sole consideration received.

(b) Debt-securities: The treatment of debt securities as boot per se for *gain* purposes, but not for loss-purposes, seems to have the effect of merely allowing an exchanging security holder with losses to control the timing of his loss deduction; thus, if he wants an immediate deduction, he can sell, if not he can hold and sell whenever the loss is more useful. Either securities are boot or they aren't; even though securities are treated as boot for gain purposes, the holder can use section 453 to defer that gain (if the paper is not "readily tradable"), but section 453 is not available for losses. I would think that the tax results that flow from an exchange of debt securities ought to parallel those that occur in a section 453 disposition. The Staff proposal allows deferral, and the control of timing, for both gains and losses. Making securities boot per se for gain and loss purposes would have the further salutory effect of doing away with the need to determine whether debt is a "security" or not.

(c) Parent-subsidiary chains: The "chain" rules of sections 356(e) and 358(c) are excessively daunting; surely we can improve upon what is trying to be accomplished in those provisions and, if we can't, maybe we should forget it. Here I believe that the proposals are trying to be excessively refined; even so, they could be materially clarified (even the Technical Explanation is inconsistent with the statutory language at one point where it suggests that boot gain could be purged by a chain liquidation while section 356(e)(2) clearly seems to state that it cannot where that provision applies). See Appendix B for examples of what I believe happens under these provisions, although I am less than wholly confident that I have fully mastered them even now, after nearly a week of intense scrutiny.

If no boot is involved, apparently the key rule here is section 358(c)(1)(A), which gives the parent corporation a substituted gain-only basis for stock received in the acquisition. Thus, that stock is "trapped" at the parent level since the parent is not a "party" to the acquisition of its target subsidiary, so that its shareholders could not exchange their parent stock for that stock in a tax-free transaction (moreover, section 311 also would tax the parent on any distribution of that stock).

Where boot is involved, sections 356(e) and 358(c)(2) are the critical provisions. After extensive and largely fruitless study, I am still defeated in trying to give meaning to section 356(e)(2) (and total inscrutability is created by the second "relating to" parenthetical phrase; presumably this material should be moved forward to follow the reference to "subparagraph (C)(i) of paragraph (1)"). Is the statement that subparagraph (C)(i) shall not apply intentional, or is it subparagraph (C) generally that will not apply? What I think is intended here is to limit taxability of the parent on boot received in a partial carryover basis acquisition to the amount of the target subsidiary's aggregate net gain attributable to its carryover basis assets. If that is the intended meaning, it's a tough struggle to derive that meaning from the provision as presently drafted.

As to the boot purge rules of section 356(e)(1), the result is somewhat clearer, but not luminously so. Here, I believe that the parent of an acquired subsidiary is to be excused from taxable gain if the subsidiary is fully taxed, i.e., it's a cost basis acquisition of the subsidiary's stock or assets. If the acquisition is a carryover basis acquisition, the parent will have taxable gain on any boot received, unless there is an upstream section 332-equivalent complete liquidation distribution of its assets within 12 months. I see no reason why this result can't be more clearly stated in the statute, as it now is in section 337(c)(3) of current law, rather than being delegated to regulations. In any event, section 333 liquidations definitely should not be permitted here, as section 337(c)(3) and section 338(c)(1) of current law so provide.

If section 332 is made to apply generally to complete liquidation distributions of a controlled corporate chain, parent losses will be unrecognized and so will gains until such time as the distributions ultimately reach shareholders in a section 331 (but not section 333) liquidation transaction. Moreover, this result ought to apply also in a section 356(e)(2) situation; as now written, however, section 356(e)(2) overrides section 356(e)(1), which I believe gives the wrong result, or at least a result that is inconsistent with the intent of section 356(e)(1). In any event, section 358(c)(2) gives the parent a new cost basis in the stock of the acquiring corporation here, thus purging that stock of any gain potential (I think). But why section 358(c)(1) requires a loss basis step-down for qualified stock received by a controlling corporate shareholder in a qualified acquisition escapes me; is this analogous to the special loss basis step-down rule under section 358(a)(2) for section 351 transactions? If it is, why should it be? I would vote for either the normal basis substitution rule or the fresh start rule, but certainly not the worst of both.

For an attempted redraft of sections 356(e) and 358(c), see Appendix C.

(d) Basis conformity rule: The special "outside basis conformity rule" of proposed section 1020 relating to a parent's basis for stock in its controlled subsidiaries may well be a sound rule in theory, but the "premium" and "discount" account rules seem to me to be an overly complex addition to deal with what I think is a relatively modest problem. Since these accounts would arise only in a case where the subsidiary's stock has been purchased for boot and an inside basis step-up election has not been made (or if they are applied across the board to all controlled groups on January 1, 1986), the typical discount case would involve the purchase of a loss company with a consequent non-election of inside cost basis in order to preserve the subsidiary's tax loss history. The converse premium case, where outside stock basis exceeds inside asset basis would typically be a situation where a cost basis election would be made. In any event, about the only virtue I can see in these accounts is that they are short-lived; in the interests of simplicity, I would either drop them completely, or shorten their lives to one year, perhaps extendable by taxpayer application to deal with a hardship case, but probably not even for this.

The effective date of this rule seems unduly abrupt; if January 1, 1986 is to be the effective date, then I withdraw any opposition to the premium and discount rules noted above, despite the quantum leap in complexity. A fairer, and certainly simpler, effective date rule in my view would be for controlled subsidiaries acquired after date of enactment; if that rule is adopted, I would drop the premium and discount rules completely since the parent would know what it is getting into in the premium case, and could protect itself in that event by a cost basis election, while the abuse potential in the discount case does not seem to me to justify the discount rule step-down for sales within three years (though it might for sales within one year in order to generate a short-term capital loss).

The rules for outside stock basis proposed by section 1020 are, in effect, quite similar to the partnership basis rules of Subchapter K and the special basis rule of Subchapter S (actually, section 1020 is closer to the "S" rules that the "K" rules since the parent does not obtain stock basis credit for its subsidiary's third party debt). In effect, a controlling parent corporation will have a constantly fluctuating basis for its subsidiary's stock which will be determined by any basis-affecting transaction at the subsidiary level, as well as by fluctuations in the amount of the subsidiary's debt. Presumably this basis could go below zero, as in the case under the "ELA" rules of the consolidated return regulations—e.g., where liabilities of the subsidiary exceed the basis of its assets. Is the intent here to repeal the investment basis adjustment rules of the consolidated return regulations? Nothing so states in the proposed statute or Technical Explanation, although the preliminary report did so provide, and the General Explanation Summary Of Proposals suggests such a repeal. I would hate to have to apply both of these rules in tandem; hopefully the final version would be more specific here.

It may, of course, be possible to manipulate outside stock basis through inside net basis-affecting transactions, at least if cash is not treated as an asset here. For example, by paying down liabilities with excess cash, this will serve to boost outside stock basis, unless cash is an "asset" with basis for this purpose, which it should be to avoid such maneuvers; also, by mortgaging assets, and paying the proceeds to the parent as a dividend, stock basis will be reduced, presumably below zero if the liabilities are large enough; and by deferring gains with a section 453 election, or electing out of section 453, outside stock basis will either be reduced or increased as the case may be. Moreover, since parent held debt (or pure preferred stock) is not subject to adjustment under proposed section 1020, the basis of these securities would be unaffected by changes in the common stock basis: I haven't thought of all the games that could be played with this rule, but I have a strong feeling that we may never know what they are until they happen. Finally, the consolidated return regulations contain a number of technical rules which will trigger the recapture of an ELA account on a subsidiary's stock, none of which apparently applies to a negative section 1020 basis. Perhaps some thought should be given to whether some of these regulation rules should be applied to this provision; e.g., insolvency, decontrol, etc. If "triggers" are adopted, presumably exceptions to their application similar to those in the consolidated return regulations also might be appropriate.

4. *Other acquisition-related proposals.* (a) Section 351: Extention of § 351 exchange treatment to an installment sale by a 20 percent shareholder under section 351(e)(2) seems to have as its only significant effect a basis step-up delay for the acquiring transferee corporation, and this is accomplished only by the Staff's Technical Explanation endorsement of a questionable proposed regulation under section 453. If this is the result desired, specific language to that effect should be inserted in section 362(a); as presently drafted, section 362(a) does not clearly support the basis delay conclusion; nor, however, does it preclude it either. My point is that we should say what we are doing in the statute, rather than in Technical Explanations or Committee Reports or regulations, since this is a rather important decision. Moreover, the question of interim resales (i.e., before the transferee corporation has completed paying off the installment notes) also should be dealt with in the statute, even if in no other way than to grant regulatory authority; presumably any gain or loss will be "flavored" by Arrowsmith notions as well.

I note that section 318 attribution does not apply for purposes of this rule, while it does for determining whether a "related party" acquisition has occurred under section 365(d). In view of the new "preemption" rules in section 351(d)(1) a related party acquisition for notes would be governed by a mandatory carryover basis rules of section 365(d); if only a partial sale of assets occurred, however, e.g., less than 70 percent of gross or 90 percent of net, section 365(d) would not apply, nor would section 351(e)(2) even though the seller was a 100 percent shareholder of the buyer by attribution under section 318; here, however, section 453(g) denies installment sale gain deferral if there is an 80 percent relationship under § 1239(b) (where special more limited attribution principles apply), but the seller can use section 453 if he proves no tax avoidance principal purpose. In other words, what we have here is substantial "relationship-discontinuity" results.

Thus, for example, an installment sale by A, a 19 percent individual shareholder, to his corporation, X, is not covered by proposed section 351(e)(2), but if the other 81 percent shareholder was W, A's spouse, section 453(g)(1) would deny gain deferral by A (unless tax avoidance was not a principal purpose) and, in any event, gain would be ordinary under section 1239(a) if the property was depreciable by X. If, however, the 81 percent shareholder was A's son, S, neither section 453(g) nor 1239(b) would apply. If A and W were both corporations wholly owned by P, another corporation (or individual), A's sale to X would be a related party acquisition under section 365(d) (if the sale was of substantially all of A's assets) though not a section 351 exchange, because A only owns 19 percent of X. A would own 100 percent of X by attribution from W to P and then to A under the related party rules of section 365(d)(5). If the P, A, W and X group filed consolidated returns (as they could if P was a corportation), A's sale would be a deferred intercompany transaction and X would get an immediate cost basis under the section 1502 regulations. If, instead, A owned 20 percent of X, new § 351(e)(2) would apply, but would be preempted by section 365(d) if the related party rules applied. In both of the above situations, sections 453(g) and 1239(b) would not apply since A does not own 80 percent of X, even under the special attribution rules of section 1239(c)(2). If the acquisition by X was less than substantially all of A's operating assets, then only section 351 (e)(2) would apply. If A owns all of X and A's spouse, B, owns all of Y, a sale of less than substantially all of X's assets to Y would not be a related party acquisition under section 365(d), but would be subject to section 453(g) (unless no tax avoidance), and to section 1239(a) if the property was depreciable by Y.

If all of the above sounds confusing and inconsistent, it is; the core problem here is the lack of a harmonious attribution system throughout Subchapter C, and, for that matter, throughout the entire Code. I question whether a provision such as section 351(e)(2), whose sole function is to match the creation of asset acquisition basis to the reporting of transferor gain, is a salutory addition to the law in this area. If we wish to overrule *Crane* v. *Commissioner*, this is certainly a devious and whimsical way to proceed.

As to the stock basis step-down rule for incorporation of loss assets proposed by section 358(a)(2), I can only note that similar doubling-up results occur in the case of gain property incorporations. Gain or loss "mitosis" has been a central feature of section 351 since its inception; this has never seemed to me to be a serious problem, but if it is perceived as such for losses, it is an equally significant problem for gains. Thus, I would either drop section 358(a)(2), or extend it for gains as well, giving the transferors a stepped-up value basis for their transferee-corporate stock. Moreover, it is not clear what result obtains if multiple assets are incorporated, some with gains and some with losses; is the section 358(a) basis traced through asset-by-asset, or do all of the transferred assets get "aggregated" to see whether the transferor's stock basis is determined under section 358(a) (1) or (2)?

(b) Section 357(b): I do not view this proposal as an improvement over current law; nor do I find the analogy to the liability assumption rules of section 1031 especially relevant or persuasive; in the latter case, the transferor is completely relieved of any economic burden when liabilities are assumed by the acquiring party in a like-kind exchange; in the former case, the transferors continue to bear indirect economic exposure to the assumed liabilities through their continued ownership in the controlled corporate-transferee. In any event, the law under section 357(b) seems reasonably well settled, with virtually no court decisions for several decades, which indicates to me at least that this provision is working quite well; the potential for abuse slight, and, if it exists, it is the fault of IRS audit coverage, not the statute; and the possiblity for future confusion significant until the parameters of what is "incident to the transferee's acquisition, holding, or operation of the property in the ordinary course of business" are worked out by regulations, rulings and case law. We don't need any more uncertainty in Subchapter C, especially when we currently have a situation in which things are working relatively well.

In other words, section 357(b) is not demonstrably broken, and the proposed "replacement part" does little, if anything, to advance the state of the union and could do much to upset the practice and burden the IRS when rulings will be sought to determine whether the assumption involves "qualified indebtedness". Moreover, the inclusion of sections 354, 355 and 356 under the "general rule" of section 357(a), and the exclusion of section 361, raises the following questions: (1) how can one ever have "qualified" debt assumptions in a section 354 or section 355 exchange (the current version of section 357(a) does not refer to those provisions, and for a very good reason—these sections deal with exchanges of stock for stock, and any liabilities assumed would, and should, be boot per se even under current section 357 and Hendler); (2) if "unqualified debt" (i.e., boot) is assumed in a carryover basis qualified asset acquisition, is this a meaningless event, or are there some lurking consequences that are not apparent in view of the fact that this is "phantom gain" that is not capable of being distributed; is such boot precluded from relief under the chain liquidation rules of section 356(e)(1)(C)(ii); if such debt is assumed at the parent level in a cost basis acquisition, is it precluded from relief under section 356(e)(1)(C)(i); and finally, is the boot portion the "value" of the liability, or its face amount (sections 357(b)(2) and 358(f) refer to "amounts," i.e., face, but the general rule of section 356(a) uses value)? In view of all of the above, I would leave section 357 alone.

General Utilities repeal

1. *The "relief" provisions—sections 1060 and 333.* The basis relief rule of section 1060 is not going to be adored by the "small business" tax advisors, to whom this provision presumably is addressed. We could help some here by changing the "formula" of section 1060(b)(1) to a more meaningful concept, viz., long-held capital asset gain less the tax attributable to that gain. While the proposed version reaches the same number, it stresses math at the expense of meaning. On a substantive point, why should the basis adjustment be limited to the shareholder's gain; if it's a true basis step-up, then it seems to me that a loss is perfectly permissible and certainly is not "abusive"; if it is to be so limited, then don't raise the section 1060(e)(1)(B) "prior" shareholder's hopes by referring to "loss" on his or her sale within six months of the transaction date. As to the corporate-level tax under section 1060(d), where the shareholder's initial basis adjustment is too large because of a later corporate tax deficiency, should not a similar rule be provided for the converse case of a shareholder basis understatement because of corporate tax overpayment? I would think so on the grounds of fairness, but the present rule leaves it up to the shareholder to pursue a refund claim (if the statute has not run, as well it might here). At least the refund limitations statute for the shareholder should be tolled in some way so as to permit the inadvertent loss of a proper claim.

I would assume that only those who could not make effective use of section 1060 would resort to section 333 (in view of the limited scope of section 1060, this may be a considerable number). I also assume that this election can be made as long as the statute of limitations is open, a refreshing change in the era of "short-fuse" binding elections. I also assume that it is not to be available where the section 356(e)(1)(C)(ii) controlled corporate chain liquidation rules are in process (as is presently the case under section 337(c)(3) and now section 338(c)(1) after 1984). In deciding whether to go with section 1060 or 333, some interesting computations will be necessary where a "mix" of assets exists at the corporate level; will we continue to permit "selective" distributions (e.g., cash to high basis stockholders and capital assets to low basis shareholders), as Rev. Rul. 83-61 does? Also, time value of money analysis will be necessary here, since section 333 is only a deferral (until death), while section 1060 is a permanent exemption of shareholder gain. I can see why this Bill no longer contains the word "simplification" in its title.

2. *Section 311-exceptions (and possible further exceptions).* Proposed section 311(a)(2) allows a recognized loss only for distributions in complete liquidation; nonliquidating distributions are not allowable losses even though basis is stepped-down to the distributees. Accordingly, the corporation must either sell its loss assets to a third person, or to a shareholder or shareholders, to avoid permanent disappearance of that loss. This seems to require an unnecessary step for no particular purpose, since section 267 will apply to defer, or deny, such losses if the relationship level is too high. If we are getting rid of General Utilities we should do so for losses as well as gains. Requiring circuitous and formalistic steps to reach the same net result was not one of the basic goals behind the Subchapter C project.

Since section 334(b) carryover basis liquidations are one exception to the general gain recognition rule of section 311(a), I would also add section 311(d)(2) carryover basis dividends to corporate shareholders as an exception. The Staff's 1983 preliminary proposal contained such an exception, and, while the 1984 Act extended taxability to all nonliquidating distributions, in my opinion that was a mistake, and I see no reason to perpetuate it in this proposal.

The case for repeal of General Utilities is grounded on a basis step-up to the property transferee; if basis carries over, gain is not to be recognized by the transferor. Distributions in-kind do not produce a basis step-up to corporate shareholders, though they will produce a basis step-down in the case of loss property. If the corporate shareholder is in "control" of the distributing corporation, I believe that an even more compelling case exists for exempting the distribution from current gain recognition treatment, whether or not a consolidated return is filed. The consolidated return regulations are on the right track when they permit tax-free movement of assets within the affiliated corporate universe, even by sale, where gain is suspended until the property leaves the group or certain other triggering events occur. Note that asset dropdowns are tax-free under section 351, even if the drop-down occurs in tandem with a qualified acquisition, by virtue of section 351(e)(1)(B); asset push-ups, by contrast, will be taxable, unless sections 332 and 334(b) apply, even though these assets are traveling on the same track in the affiliated corporate chain. This result does not make sense to me and is inconsistent with the basic premise of the acquisition proposals.

The exception for section 355 transactions is appropriate, but this only serves to exert additional pressure on that provision, and on the Rulings Division of the IRS as well, at the distributing corporation level. In fact, if the distribution of the controlled subsidiary's stock is made to a higher tier corporate shareholder, that distributee-shareholder will be indifferent to the applicability of section 355 since the dividend would be eliminated, either by the consolidated return regulations or the 100 percent section 243(b) deduction.

The final exception in section 311(d) for distributions of stock of controlled subsidiaries held for five years (with "tacking"?), subject to an anti-stuffing limitation, presumably will apply to those cases where section 355 would not—e.g., less than all, or a controlling portion, of the stock is distributed. Should not debt obligations of such a subsidiary also be included here; they are under a comparable exception in section 311(d)(2)(B) of current law? The five-year stock holding period requirement presumably will include a tacking rule, as is the case under section 355(b)(2) of current law, but the language is not specific. It is also noteworthy that section 351(e)(1)(B) allows a division to be dropped-down to a new subsidiary in connection with a qualified acquisition of that subsidiary without violating section 351 control requirement under step transaction principles.

As to the above, consider the following examples where T has an operating business, and also owns all of operating subsidiary T-1, which is turndowns all of subsidiary T-2. All corporations have appreciated assets and are profitable. If T drops its operating business into T-3, and then disposes of its stock in a carryover basis qualified acquisition solely for P stock, the initial drop-down is protected by section 351(e)(1)(B) (even though T's business was less than 5 years old), and the exchange of T-3 stock with P is tax-free. T would hold the P stock with a substituted basis and the potential gain in the P stock would be "trapped" at the T-level (distribution of that stock would trigger section 311 gain to T, and also would be taxable to T's shareholders since T stock is not "party" stock). If instead, T had spun-off T-3 stock to its shareholders before the exchange with P (and section 355 applied), T would have no gain on the distribution because of section 311(c), and T's shareholders would have no gain or loss on the distribution under section 355, nor would they have gain or loss on their subsequent exchange of T-3 stock for P stock.

If the above spin-off fails section 355 (e.g., because the T business was less than 5 years old), the incorporation and subsequent exchange with P stock both would be tax-free to T, but distribution of the P stock would be taxable to both T and its shareholders. The preliminary distribution of T-3 stock by T is taxable because the section 311(d) exception requires a 5-year holding period for T-3 stock (even if tacking is permitted).

If T drops its business assets to T-1, which in turn drops those assets to its subsidiary, T-2, and T-2 drops the assets into newly created T-3 and then makes the exchange of T-3 stock with P, the successive drop-downs are tax-free to T, T-1 and T-2 and the exchange by T-2 of the T-3 stock also is tax-free (but the potential gain in the P stock on that exchange is trapped downstream at the T-2 level). The exchange with P could be layered in at a higher rung on the T group chain ladder, with the same consequences. The only way assets could be pushed back upstairs would be by complete liquidations of the chain under sections 332 and 334(b) (and this would be protected by section 311(b) from triggering General Utilities gain).

If T-1 exchanges all of its T-2 stock with P, no gain or loss would result to T-1, but the P stock would be trapped in T-1 (unless T-1 subsequently liquidated into T under section 332). If, instead, T-1 distributes the T-2 stock upstream to T, and T then exchanges that stock with P for P stock, step-one must qualify under section 355 in order for T-1 to avoid gain on the distribution to T.

In sum, drop-downs can generally be accomplished with ease under the Staff proposals, but stock or asset "push-ups" along a chain of controlled corporations can only be accomplished via section 355 or section 332 transactions, even though both are proceeding along the same "track". This would seem to put a premium on the same sort of transactional planning that the basic acquisition proposals were designed to eliminate, and for no particular reason that I can discern. For this reason, I would recommend that an additional "exception" be added to section 311 for distributions that do not result in a basis step-up to controlling corporate distributees; in effect, I would adopt the rule accepted in both the House and Senate models of the 1984 Reform Act, before that provision was turned into a mere transition rule in Conference.

3. *Section 1257—Shareholder "flavoring" rule.* One of the carrots held out by the Staff in its proposal to repeal General utilities was its concurrent proposal to repeal the universally despised collapsible corporation provisions of section 341. They have not done so; rather there has merely been a change of venue here, and former section 341 now would reside in proposed section 1257, which is merely a slimmed down version of the notorious section 341(e). While section 1257 is short, it is by no means simple. Under that proposal, any corporate asset sale must be tested for capital gain consequences by reference to the treatment that would have resulted in the hands of its "substantial shareholders" (undefined).

By incorporating a regulation of dubious, and untested, validity under section 1375 (a provision which has even been subsequently repealed by the Subchapter S Revision Act of 1982), a situation involving a small potential for abuse has been infused with a large quantum of uncertainty. I seriously doubt whether the 18-point rate spread between corporate capital gain and ordinary income is sufficient to evoke the concern that seems to animate this proposal, which, in any event, is nothing more than a three-year holding period. In addition to the "substantial" shareholder ambiguity, this provision also retains remnants of other section 341(b) uncertainties, such as "manufactured, constructed, produced, or purchased" property, and the determination of when its holding period begins. Moreover, all of the "dealer" law of section 1221 is swept up to the corporate level on the basis of a substantial shareholder's activities outside that corporation (but considering his activities in other substantially-owned corporations).

The world has been able to function by ignoring a partner's dealer status in testing whether a partnership-level sale produces capital gain or loss (this also presumably will be the rule for S corporations after the 1982 amendments); the IRS has even so ruled in Rev. Rul. 67-188. Moreover, this result obtains in a situation where the rate spread between capital and ordinary income is 30 points, not 18. I fail to see why perpetuation of a shareholder flavoring rule for corporate-level transfers is necessary, and, if it is deemed to be essential, then at least go all the way along the section 341(e) road by adopting the more than 20 percent shareholder benchmark of that provision.

In sum, this provision seems to me to be hugely unnecessary in view of the repeal of General Utilities, inconsistent with the partnership and Subchapter S provisions, and generally incapable of predictable application. As such, I would scrap it; retention can only stimulate appeals for more generous General Utilities relief measures.

Loss Carryover Limitations

1. *Statutory structure.* I would think it possible to combine the material contained in proposed sections 382, 382A and 383 into one section, or at least section 382A could be folded into section 382, with reasonable effort. Actually, these rules probably don't even belong in Subchapter C since they are limitations on the allowability of deductions and credits provided by other sections of the Code. Thus, their proper venue would more appropriately be in section 269, which could easily be adapted to absorb these provisions within its confines, especially if section 269 is to be preempted by them, as the Staff proposal advocates. Another possible location for proposed section 382 would be adjacent to section 172, e.g., as section 172A. Finally, the organization and "order-of-proof" in sections 382 and 382A could probably be clarified; both sections contain operative and definitional provisions in no particularly logical sequence. For a proposed restructuring, see Appendix D.

2. *Substantive comments.* (a) General loss utilization—in general: If a loss corporation was attempting to maximize the use of its loss carryovers, which is the theory of the section 382 rate limitation based on the section 1274(d) long-term rate, it would not necessarily invest in long-term T-Bills; one could adopt a considerably more aggressive investment posture while still deriving a reasonably low-risk rate of

return above the rate set by the proposal. While the Staff's report states that the rate of return is a generous one, this may simply be a matter of perspective. I vote for the ABA Tax Section's two percent per month rule as being closer to real life commercial practice (exclusive of the fiduciary limitations imposed on "trusts" and the like as to the type of their investments); five years is an eternity in the marketplace, especially under present value discounting principles.

The loss limitation approach adopted by the Staff proposal seems essentially equivalent to the SRLY (or Libson Shops) taxable income limitation of the consolidated return regulations, with a further limitation based on a percentage of the loss corporation's value at the time of the triggering ownership change; the SRLY rules simply limit carryovers to the income of the quarantined member-affiliate. A *full* purchase price limitation (without the section 1274(d) rate, or any other rate, limitation) would still be "uneconomic" if all the loss corporation had was its loss carryover history (i.e., it was a shell), since the dollar of purchase price would only be buying a dollar of deduction, and the buyer thus would be out-of-pocket 54 cents. The tax effect of this transaction is equivalent to loaning a dollar to the loss corporation the day before its bankruptcy.

The first example in the Technical Explanation (at page 245) seems to have overlooked the $50,000 of post-change losses in the 1986 year of change; presumably L should be able to use those losses without limitation, either first in 1987, or as part of the 1987 carryover to 1988 (in which event the carryover would be $80,000 not $30,000). Under the ordering rule, the limited losses would be used first, but the unlimited losses (i.e., the $50,000 post-change loss) should be available to the extent L has any additional taxable income to absorb them.

I would raise the built-in-gain and built-in-loss threshold from 25 to 30 or 33⅓ percent primarily on simplicity grounds; a useful analogy here is the 70 percent asset acquisition line (or the ⅔ "substantial realization" line of the present section 341(b)(1) collapsible definition). I would also shorten the recognition period from 5 to 3 years for the same reason—that seems like more than enough time to wash-out these items. These rules, in other words, should be limited to items that are substantial in amount, and realized within a reasonably proximate time after the control change. Perhaps the built-in-loss recognition period could be retained at 5 years if the abuse potential is thought to be significant here; no such reason exists for built-in-gains; note that the "premium" and "discount" accounts in the basis conformity rules of section 1020 only last for 3 years; a similar time frame could be equally appropriate under section 382.

(b) Special rules. The successive change rules of proposed section 283(f)(1) create a mountain of complexity for a molehill problem; do we really need this? Is the concern here step-transaction abuse potential? If so, the courts have proved themselves fit for the task of policing this area, and I would continue to rely on their ability to perform that task. If there does happen to be a genuine "quick-turnover" of the loss corporation's control group, why should the first buyers be retroactively penalized because the value of the loss company declined during their short-term stewardship? Since the new buyers will be stuck with their own reduced limitation, they will have to cut back further on the "price" paid for the loss company to reflect the retroactive scale-back in the section 382 limitation. If values swing up, by contrast, the second special rule creates a tracing nightmare. All in all, neither of these rules seems to be worth the effort.

The "anti-stuffing" rule of section 382(f)(2) could use *some* tolerance for contributions to the loss company during the 2-year per-change period beyond funding the company payroll. The ABA Tax Section's proposal seems far more than reasonable on this point, and I would subscribe to their approach. Funding operating losses and the like hardly seem to be an abusive inflation of the loss company's value in anticipation of its sales, as, for that matter, would any other capital contribution made in the ordinary course of the loss company's business (e.g., temporary need for working capital, purchase of necesary equipment, etc).

If the "investment company" proposal in section 382(f)(3) must be kept—and I believe that it need not be, for reasons stated in the ABA Tax Section proposal, viz., that it is inconsistent with the neutrality principle and evocative of unnecessary complexity—then I would at least convert it to a scale-back, rather than a "precipice", rule. Moreover, some guidance should be provided as to what constitutes an "investment asset". Are we talking only about truly "passive" assets, (e.g., portfolio securities, or "net-net-leased" real estate), or does this term encompass a broader range of holdings, such as any real estate which would qualify for capital gain treatment? Where does working capital fit in here? Suppose the corporation is still in "business", but not "actively" so; is this fatal to its investment company states? Couldn't we at least import some, or all, of the investment company definition in section 354(e) for this purpose? What about temporary suspensions (e.g., a fire, and the loss company puts the insurance proceeds into CD's while waiting to rebuild or buy a new building)? Should it make any real difference whether the loss company sells its operating assets immediately before or immediately after the ownership change? It seems to me that we are getting perilously close to the business continuity rule of current law section 382(a)(1)(C), which I had hoped was being eliminated by the new proposals; the General Explanation cites this requirement as one of the principal deficiencies of current section 382(a), and I subscribe to that view.

The title 11 insolvency provisions of section 382(f)(4) seem to me to be both too generous and too restrictive at the same time. Under the staff proposal, creditors can take over control of the loss company in a title 11 proceeding without triggering the section 382 limitation, although another change within two years will wipe out the loss carryover, while outsiders are effectively barred from doing so, since the loss company's stock would be valueless if it is insolvent (as noted earlier, such an acquisition also probably would not qualify as a qualified asset acquisition either since the loss company's net assets are zero). Moreover, if the creditors capitalize their debt in the title 11 proceeding, this contribution would trigger the anti-stuffing rule of section 382(f)(2), though it would not under the ABA proposal if the debt was old-and-cold, i.e., two years old. In effect, the Staff proposal confines section title 11 proceedings to internal workouts, which is too restrictive, while allowing a total control shift to existing creditors without limitation, which seems to be overly generous, especially if the debt was recently acquired in anticipation of the taking control of the company in the title 11 proceeding.

The dinstinction between "pure preferred" stock and debt seems to be carrying a disproportionately large substantive burden in the Staff proposal. Thus, preferred stock is ignored in determining whether a triggering ownership change has occurred, but would count in applying the section 382 value limitation. Debt, by contrast, is ignored in both determinations. The draftman's art being what it is, one can readily create instruments with virtually identical characteristics, save their label as "debt" or "stock". The regulation authority conferred by section 382A(g)(2) (which is obviously inspired by section 1504(a)(5) of the 1984 Act) may provide sufficient protection against overly aggressive attempts to exploit formalities, but the regulation saga has not been a happy one, especially on the timeliness front, and may not prove equal to the task. A more straightforward approach would be to include debt in the valuation base—in effect, the section 382 limitation would be based on the loss company's gross value. An intermediate approach, adopted by the ABA proposal, would include only "aged" debt (i.e., 2 years old) that is capitalized, by conversion into equity of the loss company, either by the former owners or by the new purchasers.

(c) Limitation triggers: The Staff Technical Explanation (page 251) states that the term "owner shift" is to be interpreted broadly (e.g., to changes effected by redemption, recapitalization, conversion, new issue, etc.), but will it include a non-pro rata split-off or split-up distribution transaction as well? IRS ruled that it did not under the 1954 and 1976 versions of section 382(a) (Rev. Rul. 77-133), but the proposed statutory language of section 382A(b)(3) is certainly broad enough to encompass such transactions. But while the continuing shareholders' percentage point ownership of the loss corporation increases here, their value does not, since they merely own more of a corporation that is worth less due to the split-off distribution. Proposed section 382A(d)(4) is of no assistance here, since it is limited to value fluctuations in different classes of stock. Moreover, example (12) of Technical Explanation, which demonstrates an ownership change through a series of stock sale, new stock issue and stock redemption transactions, suggests that the split-off transaction could trigger an ownership change if it was large enough. In any event, this question should be settled clearly, one way or the other (I would vote for an exemption here).

The constructive ownership rules of section 382A(d)(1) probably exempt acquisitions from section 318-related sellers (example (17) of the Technical Explanation is the key support for this conclusion); but I would add another specific rule to the exemption list in section 382A(d)(2) which clearly so states (this is the rule under the 1954 and 1976 versions of section 382(a) as well).

Finally, if creditors exchange their debt claims for stock of the loss company, the transaction is a potential owner-shift event, unless such exchange occurs in a title 11 proceeding. This seems to me to be an unnecessarily rigid result, keyed solely to the formality of whether the loss company is in, or out, of a title 11 proceeding. Since equity swaps by solvent corporations now will trigger a tax attribute scaleback under section 108 after the Tax Reform Act of 1984 amendments in section 108(e)(10), adding a section 382 limitation to the loss company's burdens seems to me to be overly harsh result; one, but not both, of these limitations is all that need apply here. Hence, I would provide for another exception for creditor equity swaps (with a caveat that the debt not have been acquired pursuant to a plan, etc., as in the ABA Tax Section version).

Conclusion

Lest all of the above comments convey the erroneous impression that I am lacking in enthusiasm for the Staff's Subchapter C proposals, such is clearly not the case. My only attempt here has been to suggest ways in which an already outstanding effort can be improved without significant modifications to its essential premises. The world of Subchapter C will be a distinctly better one if these proposals come to pass, which I enthusiastically hope they do. I would, however, suggest a more remote effective date than January, 1986; these provisions will take some getting used to. It would also, hopefully, allow sufficient lead time to allow for regulations to be drafted before the provisions take hold, which would, in my opinion, be a very salutory thing for the tax bar at least.

STATEMENT OF ALAN J. AUERBACH, PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Professor AUERBACH. Thank you, Senator.

I am Alan Auerbach. I teach tax policy and public finance at the University of Pennsylvania. I am also directing a new project at the National Bureau of Economic Research on mergers and acquisitions.

It is probably worth pointing out that I am not a lawyer and hence not a member of the elite corps which Professor Andrews alluded to, so my testimony may sound a little bit different from everyone else's. And I should also mention that I appear on my own behalf and not representing any organization that I am affiliated with.

What I would like to talk about briefly, and what I talk about more fully in my testimony, is what the current law does to encourage or discourage mergers, and what the proposed policies would do, the advisability of the proposed policies, and a little bit on what empirical evidence there is on this subject.

There are two general points that I would like to stress here that I make in my testimony. First, as Secretary Pearlman mentioned, it is very difficult to analyze either the economic effects of the current tax treatment of mergers or the advisability of changes in that tax treatment in the absence of a consideration of what other tax changes being proposed. Just one, for example, would be the dividends-paid deduction which is now only a very small part of the proposal called "Treasury-2." But certainly, if any kind of dividend relief of a grand scale were considered, there would be a stronger reason to keep the General Utilities doctrine in place than there would be under existing law.

Likewise, the limitation of the treatment of losses that is being proposed would be less necessary if the current tax law provided some alternative transfer of tax losses without having to go through a merger.

The second point I want to make is that, despite the fact that there has obviously been an enormous amount of effort put into this proposal and the working out of proposals to reform mergers since 1976 and before, there is very, very little scientific economic evidence on this subject. There is a lot of information about particularly offensive or large mergers that catch the public eye, and there is a lot of anecdotal evidence that one can gain by talking to different people; but in terms of scientific evidence of the effects of current tax policy on actual mergers as opposed to the hypothetical incentives to merge, there is really quite a paucity of evidence.

One should view a neutral tax system as one giving firms and stockholders the incentive neither to merge nor not to merge, except for economic reasons. Put another way, it should have the effect neither of raising nor lowering the net tax burden of shareholders and firms. Obviously the current tax law achieves this effect. As I detail in my testimony, there are benefits at the shareholder level, regardless of the way the transaction is structured. But let me concentrate on what happens at the firm level.

In particular, there are two main pieces of this proposal: One is the repeal of the General Utilities doctrine, and the other is the scaling back of the treatment of net operating loss transfers.

Now, in the case of the repeal of the General Utilities doctrine, I think it is fair to say that there really is no justification for having the General Utilities doctrine or exempting from capital gains taxation the realization of gains when a liquidation occurs or is deemed to have occurred. The fact that it provides relief against double taxation ignores the fact that we have double taxation everywhere else in the system.

On the treatment of losses, I see a number of problems, as I detail in my testimony. First of all, there is no treatment at all of firms that are on the acquiring side rather than being acquired. Second, some have suggested that one of the reasons why we don't allow a refundability of tax losses, but instead discriminate against firms that achieve them, is that we think those firms are not very well managed. If this is so, then perhaps discouraging the takeover of such firms is inconsistent with current policy.

Third, I find a number of problems in the proposed treatment of built-in losses. It is too strong in the sense that it presumes an immediate realization of the losses by the firms in the event that they are not acquired. That is much stronger, I would guess, than is necessary; although, again, I think empirical evidence on that is not really available.

Finally, in my testimony, I do detail a little bit of empirical evidence, which suggests at least that taxes may be an important consideration in the merger decision, because there are a number of firms that come to mergers with tax limitations.

Senator **CHAFEE**. Thank you.

Mr. Kiefer?

[Professor Auerbach's written testimony follows:]

TESTIMONY BY ALAN J. AUERBACH

Mr. Chairman and Members of the Subcommittee: I am pleased to appear before this subcommittee to offer my views on the potential economic effects of the proposed changes in the tax treatment of merger and acquisitions that are under review. Before discussing these, however, it will be helpful to review what effects of mergers are present in the current tax law. The appropriate benchmark for comparison is a hypothetical tax system in which firms' incentives to combine are not affected by the tax system. Under such a "neutral" tax system, the taxes paid by two firms independently would be neither reduced nor increased by the act of combination, nor would the shareholders of either firm have their taxes increased or diminished by the merger.

There are many aspects of the current treatment of shareholders and firms that violate these conditions.

CURRENT TAX TREATMENT OF MERGERS

Taxation at the shareholder level

Stockholders who sell their shares as part of an acquisition may pay taxes immediately, over a short period, over a long period, or not at all, depending on the method of payment and the types of transaction involved. If the payment is in voting stock in an acquiring company and the transaction is a tax-free reorganization, no taxes will be due until the shareholder sells his shares in the new firm. If the payment is in cash, on the other hand, the shareholder must pay capital gains taxes immediately.

Whether such results are appropriate depends on what would have happened had the firms not merged. If the firms remained independent and continued to operate, with shareholders in each company holding onto their respective shares, then the tax free exchange of stock in a reorganization constitutes neutral treatment. If, however, the target company would have ceased to exist had it not been acquired, the exchange of stock permits a deferral of capital gains taxes by this company's shareholders, thus offering an incentive for the merger.

Likewise, the sale of shares for cash, though it occasions immediate capital gains tax payments, might still represent a favorable outcome for the shareholders of the acquired firm, since it allows them to get their stake in the firm out in the form of lightly taxed capital gains rather than dividends. At the same time, the potential for using share repurchases to transmit cash to stockholders is also available, and indeed is an increasingly popular alternative to dividends as a method of distributing earnings in the U.S. Thus, the opportunity to give cash to shareholders in a way that results only in capital gains taxation is available whether or not a firm is acquired for cash.

Therefore, the tax treatment of shareholders may be viewed as favorable or neutral, depending on the alternative prospects of the target corporation in the absence of a merger. I am aware of no provision in this area that discourages merger activity.

Taxation at the corporate level

Corporations can structure a combination in a number of ways, but the most important issue is whether the tax attributes of the acquired company carry over or whether this firm is treated as under liquidation, with assets being acquired with a new basis based on the firm's purchase price, and other tax characteristics, such as tax loss carryforwards, not being transferred. There are costs and benefits of the two options that must be weighed in determining which provided the new equity with the most favorable tax benefits. In a carryover basis transaction, tax losses of the target, both those already accumulated and those anticipated to occur ("built-in"), may be used, subject to various limitations, to shield the taxable income of the parent to a greater extent and faster than the acquired firm could have used them to shield its own income. This quite clearly represents an incentive for the firms to merge.

If a cost basis transaction is chosen, the target firm's accumulated tax losses may not be used, but in return the firm's assets receive what may be a substantial step-up in basis and the opportunity to obtain greater depreciation and depletion allowances than otherwise would have been received. At the same time, there may be some taxes due because of various recapture provisions that apply to these assets. However, there remains a major advantage relative to the standard case of a used asset sale: the avoidance of corporate capital gains taxes, as dictated by the General Utilities doctrine. Given the relatively high corporate capital gains tax rate, this nonrecognition of gains could in many, perhaps a majority of cases, turn a transaction that would increase the combined tax liabilities of the target and parent into one that would decrease them. In stepping up an asset's basis, a firm would not only get greater depreciation allowances deductible over time at the regular corporate rate, but would have to pay an immediate capital gains tax on the entire basis increase not already affected by recapture.

In summary, there exists corporate tax incentive to merge, if the alternative in the absence of a merger is the continuation of the target enterprise. This is true whichever method of combination is chosen. Two additional and potentially important incentives exist in both cases. They involve the current and future tax losses of the acquiring company, rather than just the target.

If a company with accumulated tax losses seeks to acquire another firm with taxable income, then this will have beneficial tax consequences similar to those that occur when the roles are reversed. In fact, there do not exist the same limitations on such use of the losses of one firm against the income of another in the case where it is a large parent that has the losses.

Even when each firm involved in a merger is currently taxable, the ability of firms to combine their taxable incomes provides a smoothing device that cannot help but reduce the possibility and extent of future tax losses incurred by the joint enterprise. The bad news that strikes one industry may leave another relatively unscathed, for example, leading inevitably to less variability in the tax base of the combined entity. This is a particular advantage in the area of conglomerate mergers, where the firms that combine are in unrelated businesses with relatively independent business risks.

THE PROPOSED CHANGES

The proposed revision of Subchapter C being considered by this committee would make numerous changes in the tax treatment of mergers. Many are intended to rationalize, simplify and make more uniform the existing provisions, by providing explicit election of tax consequences at the shareholder and firm levels and making these elections independent. On this matter, I defer to my legal colleagues on the panel, but if the provision for such elections merely simplifies activities that are already being practiced, it seems like a good idea. In making it less difficult and legally costly to arrange different combinations of shareholder and corporate tax consequences, however, you would be increasing the total tax incentives for merger activity, since firms could more easily choose the combination offering the greatest total tax advantage. This makes the proposed changes to the corporate tax treatment of cost basis and carryover basis acquisitions even more important.

Repeal of the General Utilities doctrine

The desirability of the General Utilities doctrine must be viewed not in absolute terms but in the context of the existing tax system. There is little economic logic suggesting why there should exist a tax on income levied at the corporate level beyond perhaps a withholding mechanism for the individual income tax. But such a tax does exist, and to the extent that firms continue operating, they will pay it. Why absolution should be granted simply because of a change in firm ownership is difficult to justify, unless it is desired that such takeovers be encouraged.

Indeed, the entire tax treatment of asset sales, whether through liquidation or not, is in need of reform. If asset transfers under General Utilities are encouraged, those which are taxable may very likely be discouraged in some cases, while encouraged in others. It is only by chance that the combined tax consequences of an ordinary sale of assets will net to zero.

Thus, my support for this provision is conditional on the continuation of other nonneutralities in the tax system. If, for example, some form of partial dividend relief from corporate level taxation, as proposed by the president, is enacted, this will strengthen the argument in favor of keeping General Utilities in effect.

It is difficult for me to comment on what repeal of General Utilities will do to merger activity. Corporate tax returns are themselves, of course, confidential. One can certainly learn from anecdotal accounts of the tax benefits generated by this provision in particular transactions, but this offers one little sense of the aggregate importance of such activity and the extent to which associated mergers would cease if this provision were changed. However, the need to pay capital gains taxes on very substantial increases in asset bases could easily present formidable increases in the tax costs of doing particular mergers in which the acquired company has substantial low-basis depreciable property.

Changes in the treatment of losses

The proposed legislation would introduces very careful changes in provisions governing the ability of firms to use the tax losses of firms they acquire. The treatment would differ from both current law and the yet-to-be-implemented provisions of the Tax Reform Act of 1976 in replacing limits based on the size of the target relative to the parent with limits based on the estimated ability of the target to use the tax losses in the absence of a merger. This is obviously the correct approach to take if one is interested in making the merger decision not depend on the losses of the target.

Before commenting on the specific provisions, let me point out that two of the tax benefits from merger associated with losses would not really be affected by these changes. These are the benefits associated with the use of the parent's accumulated tax losses against the earnings of the acquired firm, and the smoothing of taxable income through combination that lessens the possible impact of losses in the future for firms that do not have losses at present. It would be extremely difficult to construct a provision to reduce the second of these incentives, short of revamping the entire treatment of tax losses under the tax code. Likewise, it would be difficult to design an effective provision to limit the use of the losses of a very large parent against income of a very small acquired firm, since it is difficult to measure with any accuracy the impact of the small firm on the overall tax picture of the new entity. However, in cases where parent and target are of relatively similar premerger sizes, this problem is less severe. It is worth considering whether the incentives to takes over firms with losses should be reduced while the incentives for such firms to grow through acquisition is maintained.

The changes proposed to limit the use of tax losses to what would have been available in the absence of mergers are quite ingenious, taking account not only of the firm's preexisting tax loss carryforwards but also the "built-in" losses that may be realized after the merger takes place but which can be anticipated in advance. For firms with a substantial (i.e. at least 50 percent) change in ownership, an overall limitation on losses in each year would be established as the product of the corporate bond rate and the initial value of the firm. To this would be added recognized built-in gains, which one might interpret from their definition as taxable income, in excess of some normal level, that was predictable before the merger took place. From this sum, the firm would first have to deduct recognized built-in losses, defined in a symmetric way to gains, and could then apply tax losses carried forward from years before the merger, subject to the usual expiration. Firms with current taxable income falling short of this limit would be permitted to carry the unused portion of the limit over to the following year. There would thus be a parallel system of carrying forward losses set up; firms would now be subject to two limitations in the use of accumulated tax losses.

Built-in gains and losses would be defined in terms of the difference between the estimated market value of the firm's illiquid assets and their aggregate basis. Built-in gains would be the excess of this market value over 125 percent of the basis, and built-in losses would be the excess of 75 percent of the basis over market value. Their treatment in calculating the annual limits on the use of tax losses would be different. Whereas gains would be added to the overall limitation to the extent that the taxpayer could substantiate that they had been recognized in a given year, realized tax losses would be presumed to be realized built-in losses unless the taxpayer could show otherwise, and these losses would be stacked first against the overall limitation on the use of prior losses. I have no idea how such substantiation of gains or losses could be made, and must assume that the effect of this scheme would be to offer very little relief for firms with built-in gains and treat all losses incurred after a merger date as built-in losses. This asymmetry in treatment is understandable, given the difficulty of measuring such items and the obvious incentive for the taxpayer to err in the opposing direction. However, one must conclude that the net impact will be to discourage merger activity, assuming that the initial measurement of built-in gains and losses is reasonable.

What remains to be discussed is whether the methods used for measuring built-in gains and losses and for estimating the rate at which the hypothetical nonmerged firm would use up its prior tax losses against future income are likely to be accurate. If they are not, then the apparent neutrality gains of the new legislation would be reduced.

First, consider the plan to allow each firm taken over an annual deduction of previous losses up to amount equal to the long-term bond rate multiplied by firm value. It is, of course, a necessary compromise to choose a single rate even though firm return patterns differ. It is worth pointing out that the use of such a single rate discriminates not only against those firms with high rates of return before-tax as a fraction of market value but also, perhaps less obviously, against those with very risky and variable flows of taxable income. An enterprise that does either very well or very poorly in any given year is likely to use up previously accumulated tax loss carryforwards relatively quickly, and also likely to replace them soon after with new tax losses when the next downturn occurs. Even if this firm's before tax return as a fraction of market value has an average near the long-term rate, it would typically use up its previous tax losses much faster than would be permitted postmerger under the proposed legislation.

This is a defect about which, I believe, little can be done under a scheme such as is being proposed. There has been an obvious attempt in designing the legislation to provide a rate of allowable use of previous tax losses that is, on average, somewhat too generous, as a way of lessening this problem.

As I stated above, the additional provisions dealing with built-in gains and losses to apply in practice primarily to the latter. The concept of built-in losses, though perhaps legitimate in this context, suffers from not having been defined precisely, except de facto by the provision of the proposed act dealing with it.

Built-in losses, as I view them, can come from one of two sources. Firms can either have assets that yield before-tax returns that are low compared to book value, lower than the normal rate of return. Alternatively, they may be entitled to some tax deductions that will reduce the tax base substantially.

The first type of built-in losses just described is arguably already taken account of in the basic limitation formula. Since a firm's market value will be depressed if its assets yield a return to book value that is less than the going rate, this will lead to a reduced limitation on the annual use of losses. For example, if a firm owns assets that annually yield 6 percent before tax instead of 12 percent, the market value of the firm and its assets will be reduced until investors can expect to receive the required 12 percent. Hence, to the extent that assets are less profitable than assumed in using the long-term bond rate, this will already be accounted for by basing the limitation on market value.

The second type of built-loss, as might be associated with a firm that owns a great deal of relatively new equipment still receiving substantial depreciation allowances, requires separate treatment, since the promise of such benefits will increase rather than decrease a firm's market value. In theory one could correct this problem by deducting from the firm's market value the estimated value of these excess deductions, before multiplying by the long-term bond rate. This would have the effect of reducing the annual limitation by an amount that, on average, would equal the excess deduction in that year.

While such a scheme may not be practical, the current proposal to adjust using the excess of basis over fair market value seems aimed more at the first type of built-in loss, which requires no correction, than the second type, which does. It is difficult to say whether the net effect is too strong or too weak on the whole, since the remedy does not suit the problem. Takeovers of firms with the first type of built-in loss will be discouraged relative to takeovers of firms with the second type of built-in loss.

Thus, the proposal being considered would certainly reduce the incentive to take over firms with existing tax losses. For target firms with substantial accumulated losses carried forward, this could exert a major impact, relative to the weaker limitations now in place. The proposal falls short of its goal of neutrality in his area, both because of its treatment of built-in losses and its failure to deal with acquiring firms with tax losses.

In order to get a sense of how many megers are likely to be affected by the proposed change, it is necessary to know the fraction of mergers in which tax losses play an important role. Since detailed tax data are confidential, this is not an easy question to answer. However, using information provided on public financial statements by a sample of large firms involved in mergers, I have been able, in joint work with one of my students, to develop a picture of the potential importance of tax losses in the merger decision.

Using a sample of about 330 pairs of firms (target and parent) listed on the New York or American Stock Exchanges that merged over the period 1968–1983 (though primarily after the 1960s), we found that approximately 9 percent of the mergers involved cases where one of the firms was carrying forward tax losses and the other was fully taxable. In one tenth of these cases, it was the acquiring firms that had the tax losses. Such mergers would not be directly affected by the proposed changes. An additional 18 percent of mergers involved pairs where both firms were paying taxes but exactly one was carrying tax losses back or carrying forward unused credits. In over half of these cases, it was the target company facing the tax restrictions.

In total, just over 27 percent of the mergers in our sample were ones in which either the target company or the acquiring company was carrying forward (or back) losses or credits or both at the time of the merger. We do not know how many of these combinations were done for tax purposes. Some may have been cost basis transactions; in such cases unused tax benefits of the acquired company may have had little impact on the merger decision, since they would have disappeared soon after. However, in a number of cases, the tax loss carryforwards brought to the merger by the acquired company represented a large fraction of the firm's market value. It would be hard to believe that such mergers, though constituting only a few percent of all mergers in our sample, would not have been strongly discouraged by the proposed changes. This is particularly important now, since our data, although not necessary representative, show a greater fraction of acquired firms carrying forward losses or credits beginning in 1981. This may be attributable to the recession of 1980 as well as the greater depreciation tax benefits introduced in 1981. Our sample for this period is too small to draw any definitive conclusions about the aggregate importance of this shift.

CONCLUSIONS

The current tax treatment of mergers at both the shareholder and corporate levels encourages merger activity. This conclusion would be different if various changes that have often been suggested were enacted. One, mentioned above, would be the provision of dividend relief from double taxation. A second, justified in the past as a way of reducing the incentive to merge for tax purposes, would be the liberalized transferability of tax benefits through leasing or some other mechanism. It is desirable to have a tax system that is neutral toward mergers, but this may be accomplished either through changes in the treatment of mergers or changes in the treatment of activities that can act as a substitute for mergers. It is by no means clear that the first route is preferable under our current tax system.

The proposal submitted to this committee for changing the tax treatment of mergers would reduce corporate level merger incentives through repeal of the General Utilities doctrine and limitation of the use of previous tax losses of acquired companies. I have indicated reservations about the logic of some of the included provisions and about some of the tax incentives to merge that would remain. It is also important that changes of this nature be coordinated with changes elsewhere in the code that would indirectly influence the incentives to merge. Nonetheless, I view this proposal, if suitably revised, as a step toward reducing the role of the tax code in the merger decision.

STATEMENT OF DONALD W. KIEFER, SPECIALIST IN PUBLIC FINANCE, ECONOMICS DIVISION, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS, WASHINGTON, DC

Mr. KIEFER. Thank you, Mr. Chairman.

My name is Donald Kiefer. I am a specialist in public finance in the Economics Division of the Congressional Research Service, Library of Congress.

I would like to thank the committee for the invitation to summarize my economic analysis of the proposed revision of subchapter C, and I will submit the full report containing my analysis to the committee.

The final staff report on the Subchapter C Revision Act of 1985 states that one of the goals is that current law should be made more neutral, providing less influence over and less interference with general business dealings. The purpose of my research was to examine the proposal with respect to this goal of achieving greater neutrality within the context of the effects of the overall income tax system on incentives for corporate organization and reorganization.

The overall structure of the U.S. income tax is not neutral with regard to corporate reorganization incentives. The existence of a separate corporate income tax and the resulting double taxation of corporate equity results in a general disincentive to operate a business as a corporation.

The differential tax treatment of debt and equity in the corporate sector creates an incentive for corporations to have higher debt-equity ratios, resulting in substantial leveraging up of corporations in recent years, accomplished to a large extent through merger or acquisition, or, alternatively, financial restructuring in response to an actual or perceived threat of takeover.

The nonrefundability of tax benefits, principally the investment credit and accelerated depreciation, means that business activities which generate large tax benefits or sizeable temporary or periodic losses provide a higher rate of return if their tax benefits can be used to offset taxable income from other business activities. One way to achieve this is to combine business activities through merger or acquisition.

The lower tax rate on capital gains income of individuals puts pressure on mature firms to continue reinvesting high amounts in the corporation rather than increasing dividends. Acquiring other firms may be perceived as an attractive way of reinvesting earnings in the face of declining internal investment opportunities.

It is not the purpose of the proposed subchapter C revision to eliminate these nonneutralities which result from the structure of the overall income tax system; but these nonneutralities limit the extent to which a revision which focuses exclusively on subchapter C can make the Tax Code more neutral.

The proposed subchapter C revision would, in effect, repeal the general utilities doctrine, thus eliminating the ability to use a reorganization or liquidation to avoid the corporate-level capital gains or ordinary income tax on appreciating assets.

The proposal would also place new limitations on NOL and tax credit carryovers intended to allow approximately the same use of these carryovers as if the acquired corporation had continued to operate. This change would reduce the occurrence of mergers and acquisitions motivated primarily by the value of tax benefit carryovers of the acquired corporation.

The simplification involved in the proposal would also greatly reduce the complexity and cumbersomeness of the tax rules regarding reorganizations and liquidations. On the other hand, some of the reduced influence of the Tax Code on business structure which would result from the subchapter C revision may be partially offset by increased influences elsewhere. As one example, repeal of the general utilities doctrine could cause some appreciating property to be held outside the corporate sector in partnership form, for example, and leased to a corporation rather than having the corporation own the property directly.

Finally, it seems appropriate to conclude that the proposed subchapter C revision would have relatively limited effects on the overall level of corporate reorganization activity in the economy. This is both because many if not most corporate reorganizations are thought to occur primarily for nontax reasons and because the proposal would not affect some of the important influences of tax policy on corporate reorganizations. Enactment of the proposal, however, might be expected to reduce somewhat the number of mergers or acquisitions motivated largely by the value of tax-benefit carryovers and the number of liquidations, mergers, or acquisitions intended to avoid the corporate-level capital gains or ordinary income tax on appreciated assets. Because of the operation of the recapture rules, this latter effect would occur primarily in the extractive industries, inventory-intensive industries, and industries a substantial part of whose assets consist of intangibles, for example, the insurance industry, and among smaller businesses with appreciating real property.

As one final note, I would also emphasize what Professor Auerbach emphasized, that there is very little empirical evidence in which one can place much confidence on these effects. So these conclusions come largely from examining the nature of the tax policies themselves and what anecdotal evidence is available from specific merger and acquisition transactions.

Thank you, Mr. Chairman.

Senator **Chafee**. Thank you.

[Mr. Kiefer's written testimony follows:]

STATEMENT OF DR. DONALD W. KIEFER

My name is Donald W. Kiefer. I am a specialist in public finance in the economics division of the Congressional Research Service of the Library of Congress. I would like to thank the committee for the invitation to summarize my economic analysis of the proposed revision of subchapter C.

The final staff report on the Subchapter C Revision Act of 1985 states that one of the goals of the proposed revision is that current law should be made more neutral, providing less influence over, and less interference with, general business dealings. 1/ The purpose of my research was to examine the proposal with respect to this goal of achieving greater neutrality. The study places the analysis of subchapter C and the proposed revision within the context of the effects of the overall income tax system on incentives for corporate organization and reorganization.

The overall structure of the U.S. income tax is not neutral with regard to corporate reorganization incentives. Given several fundamental characteristics of the tax structure--the separate corporate income tax, the deductibility of interest, nonrefundable tax benefits, the treatment of capital gains and losses, and depreciation which differs from economic depreciation--the tax system will inevitably exert considerable influence on the formation, reorganization, and liquidation of corporations.

The existence of a separate corporate income tax and the resulting double taxation of corporate equity results in a general disincentive to operate a business as a corporation. Because different forms of organization have different tax consequences, the tax code greatly influences the form in which small businesses are organized.

1/ U.S. Congress. Senate. Committee on Finance. The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff, 99th Congress, 1st Session, May 1985. p. 38.

The differential tax treatment of debt and equity in the corporate sector creates an incentive for corporations to have higher debt/equity ratios. Because a higher leverage ratio can yield a higher return on equity, a management team that intends to operate a corporation with a higher debt level may be able to purchase the shares of the corporation at a premium over the market price. This pressure has resulted in substantial "leveraging up" of corporations in recent years, accomplished to a large extent through merger or acquisition or financial "restructuring" in response to an actual or perceived threat of takeover.

The nonrefundability of tax benefits (principally the investment credit and accelerated depreciation) means that business activities which generate large tax benefits or sizable temporary or periodic losses provide a higher rate of return if their tax benefits can be used to offset taxable income from other business activities. One way to achieve this is to combine business activities through merger or acquisition. While this is a non-neutral effect of tax policy regarding reorganizations, it to some extent offsets another non-neutral effect: nonrefundability can make investments by one company less profitable than investments by another company merely because of a different ability to absorb tax benefits.

The lower tax rate on capital gains income of individuals puts pressure on mature firms to continue reinvesting high amounts in the corporation rather than increasing dividends. Acquiring other firms may be perceived as an attractive way of reinvesting earnings in the face of declining investment opportunities.

Hence, some of the most fundamental structural characteristics of the income tax create incentives for corporate mergers, acquisitions and liquidations.

It is not the purpose of the proposed subchapter C revision to eliminate these nonneutralities which result from the structure of the overall tax system. Nonetheless, it must be realized that these nonneutralities limit the extent to which a revision which focuses exclusively on subchapter C can make the tax code more neutral with regard to reorganization incentives.

There are three principal incentives toward reorganization (and some more minor ones) which are created specifically by the provisions of subchapter C. First, in some cases a corporate reorganization or liquidation can be used to avoid the corporate-level ordinary income or capital gains tax on appreciated assets. This opportunity results from the statutory embodiment of the so-called General Utilities doctrine. Second, in some cases a reorganization or liquidation can be used to distribute corporate earnings to shareholders at capital gains tax rates rather than at ordinary income tax rates which would apply to dividends. Third, in some cases a reorganization can make a corporation's net operating losses and tax credit carryforwards more valuable than if the corporation continued to operate as a separate entity. (There is an obverse side to this incentive; in other cases a reorganization or liquidation can terminate a corporation's NOL and tax credit carryforwrds, thus providing a disincentive).

The proposed subchapter C revision would address two of these influences: it would, in effect, repeal the General Utilities doctrine, thus eliminating the ability to use a reorganization or liquidation to avoid the corporate-level capital gains or ordinary income tax on appreciating assets. The proposal would also place new limitations on NOL and tax credit carryovers intended to allow approximately the same use of these carryovers as if the acquired corporation had continued to operate. This change would reduce the occurrence of mergers and acquisitions motivated primarily by the value of tax benefit carryforwards of the acquired company.

The simplification involved in the proposal would also greatly reduce the complexity and cumbersomeness of the tax rules regarding reorganizations and liquidations. This would reduce the difficulty and expense of undergoing a reorganization or liquidation, reduce the influence of the tax rules on the legal structure of the transaction and reduce the risk that the tax consequences of the transaction would turn out differently than planned.

On the other hand, if the proposed subchapter C revision is enacted, the tax system will continue to exert significant influence on corporate reorganizations because of the effects which result from the structure of the overall income tax system noted earlier. In fact, some of the reduced influence of the tax code on business structure which would result from the subchapter C revision may be partially offset by increased influences elsewhere. As one example, repeal of the General Utilities doctrine could cause some appreciating property to be held outside the corporate sector, in partnership form for example, and leased to a corporation rather than having the corporation own the property directly.

Finally, it seems appropriate to conclude that the proposed subchapter C revision would have relatively limited effects on the overall level of corporate reorganization activity in the economy. This is both because many, if not most, corporate reorganizations are thought to occur primarily for non-tax reasons and because the proposal would not affect some of the influences of tax policy on corporate reorganizations. Enactment of the proposal, however, might be expected to reduce somewhat the number of mergers or acquisitions motivated largely by the value of tax benefit carryovers and the number of liquidations, mergers or acquisitions intended to avoid the corporate-level capital gains or ordinary income tax on appreciated assets. Because of the operation of the recapture rules, this latter effect would occur primarily in the extractive industries, inventory-intensive industries, in industries a substantial part of whose assets consist of intangible (for example, the insurance industry), and among smaller businesses with appreciating real property.

dg/cjw/dg

Senator **Chafee**. First of all, I want to thank each of you for staying within your time limits so carefully.

It seems to me that Professor Auerbach and Mr. Kiefer both concluded that there is not much evidence that indicates that mergers and acquisitions are driven by tax consequences. Rather it is a factor in the decision. Isn't that a correct summary of what you said?

Professor **Auerbach**. There could be a very, very strong factor; it is just that the evidence is not there to support that. The evidence is not negative either, just lacking.

Senator **Chafee**. Well, what do you say to that, Mr. Kiefer?

Mr. **Kiefer**. Well, I think I would summarize my statement that——

Senator **Chafee**. Well, if the evidence is lacking——

Professor **Auerbach**. The evidence is lacking in part because tax returns are confidential. And to the extent that we have indirect information available, there has been very little research done to date. If one talks to people involved in mergers, one often gets the impression that even in very large mergers where apparent tax benefits were achieved, taxes weren't a major consideration. Nevertheless, in a merger where a decision was close as to whether it would have taken place or not, taxes might have tipped the balance.

Senator **Chafee**. What do you think, Mr. Kiefer?

Mr. **Kiefer**. Well, I have tried to approach the answer to that question by coming at it from the other direction. We know both from anecdotal evidence and from some research that there are a lot of mergers and acquisitions that occur for nontax reasons. We also know that there are significant tax influences driving merger and acquisition which are not a part of subchapter C. And so, there are other tax influences.

Senator **Chafee**. Other factors?

Mr. **Kiefer**. There are other factors, which means, by reduction, the effects of subchapter C are limited to a subset of mergers and acquisitions, and the available evidence would suggest that it might be a small subset. But as Alan said, we don't have good evidence on it.

Senator **Chafee**. Well, Professor Andrews, what do you think of that? First of all, let us assume that, for the sake of the argument, that many of the mergers and acquisitions are driven by tax consequences. What they are saying is: "All right, assume that; but even if you change general utilities and made these other changes, there are still a lot of other tax factors out there that we are not touching."

Professor **Andrews**. I think that is quite right. I think the one I have thought was the largest is one that I thought Mr. Kiefer had alluded to, which is really the effect of the debt-equity distinction and the fact that an acquisition transaction often represents a way in which the corporations taken together can substitute debt for equity and thus reduce prospective corporate income tax burdens, or sometimes distribute cash without a dividend tax on it.

I certainly cannot add to what the economists have said about the unavailability of quantitative evidence, but I think my instinct would be that the largest tax factors driving mergers and acquisitions are probably those other ones which are not touched by this bill.

Senator CHAFEE. Would you say this would be a small step?

Professor ANDREWS. I think, as to the pushing of acquisition transactions that might not otherwise occur, my instinct is that this legislation would be a limited step in the right direction, yes.

Senator CHAFEE. While I've got you, Professor Andrews, could you describe the ALI project that you worked on? There is some suggestion that you were only in touch with academics when you did that study. Could you tell us a little bit about how you did it?

Professor ANDREWS. Well, I will start by saying that I don't agree with that conclusion at all. The American Law Institute is an institution that includes tax academics, but I think the leading people in it are judges and practicing lawyers, and the tax work is done largely by tax practitioners and tax academics. I think the ratio is something like 8 : 2. Let's say 80 percent practitioners and 20 percent academics.

Senator CHAFEE. Substantially all.

Professor ANDREWS. Now, in our particular project there was a group of consultants, a dozen consultants of whom two or three were academics and the rest were practitioners; and then there was a tax advisory group that met and deliberated on these proposals three or four or five times, and that group was largely tax practitioners with some academics included. But I think it would be a mistake to think that the work of the Institute was dominated by academics in any way.

Senator CHAFEE. What do you think of the ABA recommendation on the net loss carryover; that is, allowing net operating losses of 24 percent of the purchase price over 5 years?

Professor ANDREWS. Well, I think it is one of a set of proposals, any one of which would represent a great improvement over the present state of the law.

Senator CHAFEE. Better or worse than the committee recommendations?

Professor ANDREWS. I prefer the committee staff recommendation, and that is chiefly based on the different rate. But I want to emphasize that I think the similarities between the two proposals are greater than their differences.

I prefer the staff rate, which is a somewhat lower rate, running for a longer period of time, for the reason that it comes a little bit closer to replicating the likely value of the loss carryover if something had been done other than an acquisition transaction. That is, if you allow the deductions to be taken faster, they give a relative advantage to larger acquiring corporations as compared with smaller ones. Also the faster rate of deduction fails to discriminate between loss carryovers that are about to expire and those that have a long life left, in the way that the staff proposal does.

Senator CHAFEE. How about you, Professor Eustice? What is your thought?

Professor EUSTICE. I have sort of waffled back and forth on this; I have no terribly strong feeling one way or the other. There is a point, I think, that was brought home to me after I had submitted my written testimony, and it is too late to unwind it; but what we are doing in both the staff and the ABA proposal is giving a guaranteed survival of these tax benefits, risk-free if you will, as opposed to the present marketplace system where both sides sit down and calculate the risk of survival of the loss carryover under 269 in the present law, and discount the purchase price accordingly. That, of course, gives a higher rate of return. In that respect, I think the staff rate may not be too far off the mark.

Senator **CHAFEE**. In summary, Professor Andrews, you are for the committee staff report, right?

Professor **ANDREWS**. Yes, sir.

Senator **CHAFEE**. You are for it, Professor Eustice?

Professor **EUSTICE**. Yes, sir.

Senator **CHAFEE**. You are for it, Mr. Kiefer?

Mr. **KIEFER**. I am not really in a position to characterize myself as for or against it.

Senator **CHAFEE**. Well, I will characterize it.

Mr. **KIEFER**. OK. That's fair. [Laughter.]

Senator **CHAFEE**. And tell me exactly where you stand, Professor Auerbach.

Professor **AUERBACH**. Have I been sufficiently ambiguous? With potential revisions I would be in favor of it.

Senator **CHAFEE**. With what revisions?

Professor **AUERBACH**. With revisions to the treatment of built-in losses. And perhaps to somehow bring in treatment of companies——

Senator **CHAFEE**. No, we can't bring any more treatment in.

Professor **AUERBACH**. OK. If you ask me just to vote yes on this——

Senator **CHAFEE**. Yes or No.

Professor **AUERBACH**. I would vote Yes.

Senator **CHAFEE**. All right, fine.

Well, thank you all very much. I appreciate your coming down.

Will the next panel come up? I have to take about a 3-minute break and will be right back.

[Whereupon, at 10:55 a.m., the hearing was recessed.]

Senator **CHAFEE**. All right, our next panel consists of Hugh Calkins; M. Bernard Aidinoff; Dale S. Collinson, accompanied by Herbert L. Camp; and Evelyn Low.

Mr. Calkins, please proceed.

STATEMENT OF HUGH CALKINS, CHAIRMAN, AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, CLEVELAND, OH

Mr. **CALKINS**. Thank you, Senator Chafee.

My name is Hugh Calkins. I am chairman of the tax section of the American Bar Association, and I appear here today as a representative of the American Bar Association to present its position with respect to title III of the Subchapter C Revision Act—title III, of course, relates to the net operating loss carryovers. Because neither the tax section nor the ABA have had an opportunity to take an official position with respect to titles I and II. I will present no testimony on those important subjects; but I am accompanied by M. Bernard Aidonoff, a former chairman of the tax section, who will present individual comments with respect to both topics.

With me also is Robert Jacobs, formerly a chairman of our tax section's committee on corporate stockholder relationships, who will assist me in answering your questions relating to the net operating loss subject.

At the outset I would like to make three points:

First, the ABA supports title III. Even if no changes were made in it, we would urge this committee to approve it and the Congress to enact it. It is a great improvement on both the present law and on the 1976 amendments which are scheduled to take effect on January 1.

Second, the Tax Section commends the staff, the Chairman, and the committee on the procedure which this bill reflects. It is, in our view, exactly the right way to deal with complex portions of the Internal Revenue Code. We hope that the procedures which began with the installment sale changes some years ago and continued through the subchapter S revision more recently and are now reflected in this Subchapter C Revision Act will continue their steady course.

Through those procedures, we hope that we can approach much more closely than at present the universally-acclaimed objectives of simplicity, conformity to reasonable expectations, and neutrality in the tax law.

Third, this act promotes all three of those objectives. It eliminates the all-or-nothing aspect of present law relating to net operating losses; it makes the transfer of a loss company a neutral act by according approximately the same value to a loss whether the transaction takes place or not; and, once communicated, the neutrality principle makes all of the necessary line drawing and abuse-prevention provisions understandable and predictable.

In short, we are enthusiastically in support of title III of this act.

There are only six significant differences between the proposal and statutory language which the ABA approved in February 1985 and the proposed statutory language in the staff report. The ABA respectfully calls attention to these differences and urges that its recommendations be carefully considered by the committee.

The five most important differences are:

First, both staff and ABA achieve the neutrality principle by limiting the carryovers to a percent of the purchase price and a number of years during which a loss can be carried forward.

As the previous discussion has indicated, there is a considerable difference between the ABA proposal and the staff proposal in this regard. The ABA proposes 24 percent of the loss each year for five years, while the staff proposes the Treasury rate and a 15-year period. The ABA prefers its proposals because it thinks it more realistically reflects the realities of the business world: businessmen do not think out much beyond a 5-year span, and the rate of return on a company with losses ought to be the equity return and not some kind of a bond return.

Second, we have a difference with respect to the trigger. We both say it should be 50 percent. The staff wants all changes within 3 years to count, and the ABA wants only related changes to count.

Third, the concept of the bill requires an anti-stuffing rule, and there is an important difference between the staff proposal and the ABA with respect to debt. The ABA believes that its proposal more realistically reflects the situation of small companies where, typically, the principal shareholders are also creditors.

Fourth, there is a significant difference with respect to how creditors are treated in loss-workout situations. The staff wants to limit that to a Chapter-11 Bankruptcy Act kind of proceeding, and the ABA would favor a more informal workout along the lines of what section 108 of the code now provides.

Finally, fifth, there is a difference between the style of drafting. It takes the staff 480 lines to draft its proposal; the ABA did it in 210 lines. We think the shorter version is better, because the neutrality principle is sufficiently easy to understand that regulations can flush out the fine points.

Thank you, Mr. Chairman.

Senator **Chafee**. Thank you, Mr. Calkins.

Mr. Aidinoff.

[Mr. Calkins' written testimony follows:]

Statement of Hugh Calkins,
Chairman, Section of Taxation
of the American Bar Association
Before the Committee on Finance
United States Senate

September 30, 1985

I am Hugh Calkins, Chairman of the Section of Taxation of the American Bar Association. I am pleased to be here to present the views of the American Bar Association on those portions of The Subchapter C Revision Act of 1985 that relate to limitations on net operating losses and other tax attributes, as well as those portions of the report of the Staff of the Committee on Finance ("Final Report") that deal with this subject.[1]

Before commencing discussion of the subject of limitations on net operating loss carryovers, I would like to comment briefly on the process by which the Subchapter C Revision Act of 1985 has evolved.

The proposals contained in the Revision Act are refinements of earlier proposals contained in a preliminary report ("Preliminary Report") in 1983 by the Finance

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[1] Staff on the Senate Committee on Finance, "The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff," 99th Cong., 1st Sess., S. Print 99-47 May, 1985.

Committee Staff.[2] We testified at hearings held on October 24, 1983, on the Preliminary Report. Helpful testimony was also received from the Department of the Treasury, other bar associations, practitioners, academicians, and representatives of business. Since then, the Staff has worked in cooperation with the representatives of other Congressional staffs, the Treasury Department, the Internal Revenue Service, and a group of practitioners and academicians to review and improve the proposals in light of the testimony given at those hearings. Members of the Section were invited to participate, and did so actively, in this process. In addition, several of our substantive committees have studied the proposals extensively and our full membership has been exposed to several programs exploring the operation of the proposals.

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[2] Staff of the Senate Committee on Finance, "The Reform and Simplification of the Income Taxation of Corporations," 98th Cong., 1st Sess., S. Print No. 98-95 (Sept. 22, 1983). The Preliminary Report was based in large part upon recommendations contained in a detailed, thoughtful study prepared by the American Law Institute, recommendations of the Section of Taxation of the American Bar Association, and the other materials cited in the Final Report.

The Final Report is quite detailed, not only explaining the proposals themselves and providing the specific statutory language for the suggested changes to law, but also discussing the respects in which the proposals in the Final Report were and were not modified from the earlier proposals in response to testimony at previous hearings. The Final Report has been published for several months, and in the interim, representatives of the Staff have been forthcoming in discussions of the proposals at meetings of our Section and elsewhere.

We applaud and sincerely appreciate the manner in which these proposals have been formulated. The process I have just outlined should serve as a model for the development of legislation of this type. I am confident that all who took part in this effort believe that the final product was improved by the contributions of their colleagues.

We are aware that the changes proposed are fundamental changes which will have a wide impact on business transactions, large and small. Such changes should be made with caution and with the humility to recognize that, even at this point, none of us sees their full implications. Moreover, we have examined the proposals with the knowledge that we have yet fully to comprehend the substantial revisions made to the tax law in 1981, 1982, and 1984, let alone those proposed by the Administration and currently being considered by this Committee and the House Committee on Ways and Means. However, unlike much of the recently enacted legislation and that which would be necessary to enact the Administration's proposals, the Subchapter C Revision Act is the result of years of study and analysis. This record is set out in the Final Report and need not be repeated here.

My testimony today on behalf of the American Bar Association is restricted to the subject of limitations on net operating losses and other tax attributes. That restriction is occasioned by the fact that the Association has not yet had the opportunity to articulate an institutional position on the broader subject of corporate acquisitions. We are proceeding promptly to do that. This subject will be addressed at the forthcoming mid-year meeting of the Section of Taxation. We will there evolve a Section position and will submit that for Association action. Until these actions have been taken, I am unable to speak for the Section or the Association on this important topic.

I turn now to the proposals contained in the Final Report affecting the limitation of net operating losses and other corporate attributes (the "Staff Proposals"). This is a matter on which the American Bar Association has adopted a formal position, and on which my immediate predecessor, James B. Lewis, testified before the Subcommittee on Select Revenue Measures of the House Committee on Ways & Means on May 22nd of this year. This is an important matter and one for which Chairman Packwood sought responses to a number of questions.

The rules governing the carryovers of net operating losses and other tax attributes ("Section 382 Attributes") following certain corporate transactions, presently contained in sections 382 and 383, present special opportunities and difficulties. We have a special opportunity, because working both together and separately over the past several years, the Section of Taxation and the Staff of the Committee have achieved a remarkable degree of consensus as to the proper approach to this difficult and often controversial area. This should enable the Section to provide the Committee with constructive assistance as you continue to develop your proposals.

The special difficulty is that there is a degree of urgency: absent affirmative action by the Congress, the 1976 amendments to sections 382 and 383 will take effect on January 1, 1986. The Association believes that the 1976 amendments are too complex and in many respects arbitrary and irrational, and that it would be a serious mistake to allow them to become effective. Even if Congress takes no action this year regarding Subchapter C generally, it may wish to address and remedy that area this year. Fortunately, sections 382 and 383 are susceptible to revision either separately or as part of comprehensive reform.

Shortly before the release of the Final Report in May of this year, the Section and the American Bar Association adopted a legislative recommendation proposing that the problems in sections 382 and 383 be resolved by a single rule permitting carryovers of Section 382 Attributes based on the value of the loss corporation prior to the change in control. The legislative recommendation has been put in statutory language accompanied by a report reviewed by the Section's Council (the "ABA Recommendation"; a copy is attached). I commend it to you.

The guiding principle utilized by the ABA Recommendation in limiting the carryover of Section 382 Attributes from the seller to the purchaser of a corporation is "neutrality." Under this principle, the value of a corporation's Section 382 Attributes should be the same in the hands of the purchaser as they were in the hands of the seller. A change in corporate ownership should neither enhance nor diminish the value of the Section 382 Attributes, and a well-informed taxpayer should not undertake tax-motivated corporate acquisitions.

The Staff Proposal is also based upon the neutrality principle, and is wholly consonant with the resolution formally adopted by the ABA; it shares many other specific features of the ABA Recommendation as well. Under each, the motive of the taxpayer and business continuity are irrelevant; all corporate acquisitions, both taxable and nontaxable, are subject to one rule; and the "all or nothing" approach to the survival of Section 382 Attributes that sometimes prevails under present law is eliminated. We fully endorse these features of the

Staff Proposal. These broad points of similarity indicate the degree of consensus between your staff and the ABA, and enable the ABA to support the general approach taken in the Final Report without reservation.

In fact, the distinctions between these two independently developed reform proposals really are not differences in policy, but merely in the means of implementing policy. There is one general respect in which the ABA Recommendation offers advantages over the Staff Proposal, and several specific differences between them that warrant note. In general, the statutory language and scheme embodying the ABA Recommendation is briefer and less complex than the staff proposal, and relies more heavily on familiar concepts developed under existing law than does the Staff Proposal.

Both proposals measure the permitted carryover of Section 382 Attributes by reference to the value of the acquired corporation, as evidenced by the purchase price. Both reject the notion that the carryover, once limited in amount by reference to the purchase price, should be available immediately in full; this notion would unjustifiedly favor large purchasers that can use all of the losses currently over smaller purchasers with lesser abilities to generate income.

One matter of important detail as to which they differ is the time over which the permitted carryover may be utilized. The Staff Proposal spreads utilization over a period of up to fifteen years, permitting the use each year of an amount equal to the product of the purchase price and the applicable long-term Federal rate ("AFR") at the time of the purchase. The ABA Recommendation permits the utilization of losses in an amount equal to 2% of the purchase price for each of the first 60 months, or 120% of the purchase price by the end of five years, following the change in control. This 120% of the purchase price formula and the Staff Proposal formula both seek to approximate, in present value terms, the value of the losses to the buyer and the seller. The merits of the respective mathematical formulae behind the two proposals are subject to debate -- and we welcome further refinements -- but we believe the five-year approach of the ABA Recommendation has certain comparative advantages that the Committee should consider:

- First, our experience is that business people seldom place significant value on potential Section 382 Attribute utilization much longer than five years out. Making a potential purchaser alter his calculus to consider a longer term, although perhaps sound in theory, begins to strain the neutrality principle in practice.

- Second, we believe that the owner of a business generally expects a return on his investment of at least 20% -- substantially in excess of the safe rate of return represented by the AFR. Again, the neutrality principle in practice requires the shorter term with the higher annual utilization rate. That expectation is no less real, notwithstanding that experience teaches that the average rate of return is less than the AFR.

Another important concept on which our two proposals basically agree is the type of event that triggers the limitation of Section 382 Attribute carryovers. Under both proposals, a 50% change in equity ownership is required, excluding certain transfers involving small shareholders, gifts, bequests, divorce settlements, related parties, and bankruptcy situations. Our approaches differ, however, on how and under what circumstances to combine several different transactions to determine whether a qualifying change in ownership has occurred.

The Staff Proposal provides that all transactions within a three-year period are combined to test for 50% equity changes. The ABA Recommendation is less mechanical, combining all "integrated" transactions without regard to a specific time frame. We recognize that the absence of a time limit introduces a measure of uncertainty. However, we believe that policy requires only the consideration of related events, and that fairness requires that wholly unrelated transfers not be stepped together. For example, the purchaser of a substantial minority interest (e.g., 45%) in a loss corporation should not have the value of his investment exposed to the risk that, any time within the three years following his investment, another minority (e.g., 10%) shareholder may sell enough of his stock to an unrelated party to trigger a change in ownership and hence a curtailment of the corporation's Section 382 Attributes. Other types of transactions similarly may be beyond the control or anticipation of a purchaser of a minority interest (e.g., the exercise of stock options, or a required purchase pursuant to a shareholder buy-sell agreement or an employment contract). The uncertainty introduced by an all-encompassing three-year test period could impair the ability of good faith buyers and sellers to achieve a fair price for the sale of a substantial minority interest in a loss corporation, detracting from the effective application of the neutrality principle.

A third area in which the ABA's approach diverges from that of the Staff Proposal deals with the treatment of loss companies with substantial investment assets. The Staff Proposal would deny any Section 382 Attribute carryovers to a change in ownership of an "investment company" (defined as a corporation at least two-thirds of the assets of which are held for investment). After careful consideration, any such limitation was excluded from the ABA Recommendation as unnecessary and, ultimately, counterproductive.

A limitation based on investment assets is inherently inconsistent with the neutrality principle that is the cornerstone of both our proposals. Under the Staff Proposal an "investment company" with Section 382 Attributes will necessarily be less valuable to a potential purchaser than to its present owners, and economically reasonable transactions will be thwarted. This rule seems particularly inappropriate when the "investment company" operates a small trade or business in addition to holding investment assets. A knowledgeable purchaser who could increase the profitablity of that business, perhaps by converting investment assets to a more productive use, will be unable to agree upon a purchase price with a knowledgeable seller. Neither sound economic policy nor the neutrality principle are well-served by that result. Nor is such a rule necessary: the neutrality principle alone should be sufficient to make "trafficking" in inactive loss companies uneconomical. We are are also concerned that the inclusion of an "investment company" rule will introduce substantial unwarranted uncertainty and complexity as to the meaning of "investment assets" into both the bargaining and tax administration processes.

A fourth difference between our approaches involves the treatment of certain debt of the loss corporation that is acquired by the purchaser. Both proposals contain a so-called "anti-stuffing" rule designed to prevent inflation of the value of the loss company by asset infusions prior to a change of control. However, the ABA recommendation would exempt from this rule the conversion of outstanding debt into equity, so long as the debt had been outstanding longer than two years as of the change in control. This approach appropriately recognizes that amounts paid for both equity and debt are ingredients in measuring the purchase price, and hence the value, of the loss corporation. This rule will find frequent application in purchases of closely held corporations, whose controlling shareholders often are also creditors. We urge that you give favorable consideration to including such a provision in your proposal.

A final distinction between the Staff Proposal and the ABA Recommendation that warrants comment is in the treatment of insolvent loss companies. The Staff Proposal exempts from the general rule limiting the carryover of Section 382 Attributes following a change in control the situation where the former shareholders combined with the former creditors own 50% or more of the stock of the corporation after the change in control, but only if the corporation is subject to a Title 11 or similar court proceeding. The ABA Recommendation takes a similar approach, except that we would not limit the exception to corporations under the jurisdiction of a court. Rather, we recommend that the conversion of "old and cold" debt to equity generally be recognized, as described above, and also that acquisitions of stock by creditors in exchange for claims against the corporation generally not be considered in determining whether a change in control has occurred, provided that the claim was not created or acquired principally to obtain the stock, and that the stock is received in a "qualified workout" in which a majority (in amount) of creditor claims participate. To permit taxpayers to avoid the delays and costs of court proceedings, we recommend that a qualified workout definition be adopted, and for this purpose, it may be appropriate to refer to the elements contained in the section 108(e)(10)(C) definition.

In summary, although I have perhaps emphasized in these remarks the differences more than the similarities between our two approaches, I am very pleased that these differences are largely technical questions of implementation, and not basic policy issues. The American Bar Association supports the general approach embodied in the Staff Proposal, and we are prepared to offer the Committee our full assistance to produce a bill that accomplishes a final reform of sections 382 and 383, and that incorporates the best features of both our proposals.

STATEMENT OF M. BERNARD AIDINOFF, PARTNER, SULLIVAN AND CROMWELL, NEW YORK, NY

Mr. AIDINOFF. Mr. Chairman, I am a partner in the law firm of Sullivan and Cromwell. I am one of the practitioners who participated with the committee staff in the detailed consideration of the final report. I served also as a consultant on the subchapter C study of the American Law Institute. I am here to present my personal views and not those of any client.

I believe that a more cohesive and more rational regime for the taxation of corvorate acquisitions is needed. The proposals in the final report would replace an often illogical patchwork of rules with a coherent scheme that should be much easier to understand and apply in practice.

I recognize that with any new enactment, even one which on balance is simplifying, there will be a period of time when unfamiliarity with the new scheme will cause some to question whether simplicity has truly been achieved. This is not a serious cause for objection to the report's proposals. The proposed Revision Act would be a considerable improvement over current law. Accordingly, I strongly urge that the staff report be introduced in bill form and that the legislative process go forward. The basic spadework has been done, and the time to move is now. Any bill should not be restricted to merely changes in sections 382 and 383.

Chairman Packwood's announcement of these hearings requested comments on several major issues, which I will now address in the order in which they were presented in that announcement.

I support the proposal to allow the corporate parties to an acquisition, explicitly to elect whether at the corporate level to treat the acquisition as a sale—that is, a cost-basis acquisition—or as a nonrecognition transaction akin to the current treatment of reorganizations—that is, a carryover basis acquisition—regardless of the nature of the consideration used to effect the acquisition. I believe this proposal is sound: The explicit election would be a simplification of the current system, which in effect permits elective treatment through tinkering with the form of the transaction.

The proposal would allow shareholders of an acquired corporation to receive, tax free, stock of an acquiring corporation or its parent or grandparent regardless of whether the corporate parties treat the acquisition as a cost-basis acquisition or a carryover-basis acquisition, and regardless of the amount of consideration other than stock used to effect the transaction. Both changes would be improvements over current law.

The linkage of shareholder taxation to the tax treatment of the corporate parties cannot be explained as a natural consequence of the policies underlying the taxation of acquisitions. The linkage subjects shareholders who receive solely stock of an acquiring corporation to tax if the reorganization fails for any reason. This just does not make sense.

Separating the taxation of one shareholder from that of other shareholders also is desirable, and I support that feature of the proposals.

Senator Packwood asked for comment on the uniform definitions for qualified acquisition, I support the proposal. My only comment with respect to the proposal is that the partial continuance of the "application of the consistency principle" in the proposal is unnecessary once the various other changes are made.

A comment on general utilities. I support the repeal of general utilities but recognize that some adjustment is necessary in order to offset the effect of double taxation. The basis adjustment proposal of the committee staff is a splendid one, but I see no reason why that adjustment should be limited to small acquisitions. There is no reason that the basis adjustment principle should not be applied in every liquidation situation.

I will not comment on the net operating loss provisions other than to say that I am in agreement with the views expressed by Mr. Calkins.

[Mr. Aidinoff's written testimony follows:]

STATEMENT OF

M. BERNARD AIDINOFF

I am M. Bernard Aidinoff. I am a partner in the law firm of Sullivan & Cromwell, and I am a past Chairman of the Section of Taxation of the American Bar Association. I am pleased to be here to present my views on The Subchapter C Revision Act of 1985 and the report of the Staff of the Committee on Finance ("Final Report") containing the proposed Revision Act.[1] I believe that these views are representative of the views of most of the members of the tax bar who participated with the Committee's staff in the detailed consideration of the Final Report.

We join Mr. Calkins in applauding the manner in which the proposals contained in the Final Report have been formulated. The process should serve as a model for the development of legislation of this type. We are confident that all who took part in this effort believe that the final product was improved by the contributions of their colleagues.

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[1] Staff on the Senate Committee on Finance, "The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff," 99th Cong., 1st Sess., S. Print 99-47 May, 1985.

We believe that a more cohesive and more rational regime for the taxation of corporate acquisitions is needed and we support the objectives of the proposals to achieve simplification, tax neutrality, elimination of tax motivated transactions, and increased compliance. Commentators previously have been hampered in their ability specifically to endorse the proposals described in the Preliminary Report[2] by the absence of specific statutory language which would implement the proposals. Based on our study to date, we believe that the proposals set forth in the Final Report would generally accomplish the stated objectives. The proposals would replace an often illogical patchwork of rules with a coherent scheme that, when fully understood, should be much easier to understand and to apply in practice. We recognize, however, that with any new enactment, even one which on balance is simplifying, there will be a period of time when unfamiliarity with the new scheme will cause some to question whether simplicity has truly been achieved. Our personal belief is that this is not a serious cause for objection to the Final Report proposals.

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[2] Staff of the Senate Committee on Finance, "The Reform and Simplification of the Income Taxation of Corporations," 98th Cong., 1st Sess., S. Print No. 98-95 (Sept. 22, 1983).

Subject to our comments elsewhere in this testimony, the Revision Act would be a considerable improvement over current law. Accordingly, we strongly urge that the staff report be introduced in bill form, and that this Committee conduct such additional hearings as may be necessary. As the legislative process moves forward, we stand ready to continue our advice and assistance to the Committee staff for further technical analysis and improvement.

We point out that our endorsement of the basic principles of the proposals, and of the draft statute as generally achieving those principles, does not constitute approval of each and every provision of the draft statute. There remain two fundamental issues which are described below. In addition, members of the American Bar Association Section of Taxation and others are currently reviewing the technical workings of the proposed statute. It is highly likely that, as the proposals are carefully considered, a number of suggestions will be advanced that will improve the legislation.

Concerns with the proposals for taxation of corporate acquisitions appear to have narrowed and at this point appear to focus on but two fundamental issues: (1) the form of relief that should accompany taxing corporations on liquidating distributions; and (2) the substantial, and we believe unnecessary, complexity that will result from implementing a battery of so-called "consistency rules" to prevent one corporation from acquiring some assets from a target corporation with a tax basis equal to the purchase price while also acquiring other assets from the target corporation with a tax basis equal to the target corporation's basis. The grounds for our concerns with these aspects of the proposals are discussed in detail below.

At this point, I wish to emphasize that failure adequately to resolve these issues runs a risk of jeopardizing broad-based support for the proposals as a whole. With that qualification, I can state that, as the proposals have become more generally understood, they have been generally well-received. The few broad issues and various technical questions which remain are appropriate to resolve in the course of the legislative process begun today.

Chairman Packwood's announcement of these hearings requested comments on several major issues which I will now address in the order in which they were presented in that announcement.

Electivity of corporate-level taxation in qualified acquisitions. We support the proposal to allow the corporate parties to an acquisition explicitly to elect whether, at the corporate level, to treat the acquisition as a sale (a "cost-basis acquisition") or as a nonrecognition transaction akin to the current treatment of reorganizations (a "carryover-basis acquisition"), regardless of the nature of the consideration used to effect the acquisition. We believe that this proposal is sound for several reasons. First, the explicit election would be a simplification of the current system which in effect permits elective treatment through tinkering with the form of the transaction. For example, carryover-basis treatment can be avoided by poisoning the consideration with a prohibited amount of non-qualifying consideration ("boot"). Carryover-basis treatment at the corporate level can be obtained in an acquisition solely for cash as long as it is structured as a stock purchase. Statutory and judicial requirements that a quantum of stock be issued and retained by the recipients in a reorganization are frustrated by undetected sales of stock, especially in transactions involving publicly held corporations. The ability to effect a reorganization with nonvoting preferred stock and a taxable acquisition with long-term debt securities suggests that the choices are largely formalistic. Simplification is desirable because the implicit election of current law is not, as a practical matter, equally available to all. The more sophisticated are able to exercise more latitude in their choice of tax consequences than are the less well-informed.

Second, the explicit election would remove innumerable snares often hidden in current law. One would never predict, as a matter of intuition, for example, that an acquisition by a subsidiary for its parent corporation's stock is taxable merely because the subsidiary has outstanding a class of nonvoting, preferred stock owned by another shareholder. A list of other hidden snares could be prepared to support this point.

Third, eliminating the requirements for specific types of consideration to be used to effect nonrecognition transactions will make acquisitions easier to accomplish in accordance with the business objectives of the parties.

Separation of shareholder taxation from corporate taxation. The proposal would allow shareholders of an acquired corporation to receive tax free, stock of an acquiring corporation or its parent, grandparent, etc., regardless of whether the corporate parties treat the acquisition as a cost-basis acquisition or a carryover-basis acquisition and regardless of the amount of consideration other than such stock used to effect the acquisition. Both changes would be improvements to current law.

The linkage of shareholder taxation to the tax treatment of the corporate parties cannot be explained as a natural consequence of the policies underlying the taxation of acquisitions. This linkage subjects shareholders who receive solely stock of an acquiring corporation to tax if the reorganization fails for any reason. Similarly, tax-free treatment at the shareholder level bars the acquiring corporation from stepping up the basis of the acquired assets. Uncoupling these results should facilitate transactions, and yet assure that a tax is imposed if the acquiring corporation wishes to step up the basis of acquired assets. Shareholders would be entitled to nonrecognition based solely upon whether they receive stock. The decision to take a cost or carryover basis would then turn solely upon whether the corporate parties determine that it is an appropriate time to recognize taxable gain and to step up the basis of the acquired assets.

Separating the taxation of one shareholder from that of other shareholders also is desirable. This feature of the proposals would reverse the often criticized result in the May B. Kass[3] case. Arguments in favor of jettisoning the continuity of interest doctrine of current law to allow nonrecognition treatment have been well made elsewhere.[4] However, those arguments seem especially compelling when considering that a shareholder can be taxed on the receipt of stock because other shareholders promptly sold the stock they receive in the same transaction.

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[3] Kass v. Comm'r., 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974).

[4] Wolfman, "Continuity of Interest" and The American Law Institute Study, 57 Taxes 840 (1979); Faber, Continuity Of Interest And Business Enterprise : Is It Time To Bury Some Sacred Cows? 34 Tax Lawyer 239 (1981); Jacobs, Reorganizing The Reorganization Provisions, 35 Tax L. Rev. 415 (1980).

Uniform definitions for "qualified acquisitions." For some time the Section has been troubled by the multiplicity of definitions of transactions which constitute tax-free "reorganizations" and by substantial differences, often unjustified as a tax policy matter, between the requirements to satisfy one definition or another. Under present law, substantially identical transactions may yield substantially disparate consequences. In Tax Section Recommendation 1981-5 [5], the American Bar Association adopted a recommendation that these definitions be simplified and made more uniform. In making that recommendation the Section felt constrained to retain the basic continuity of interest requirement of current law. That constraint grew more out of the defined scope of the project leading to the Recommendation as a "Narrow Project" rather than out of a conclusion that any continuity of interest is a sound requirement of nonrecognition treatment.

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[5] 34 Tax Lawyer 1386 (1981).

Consistent with the foregoing we strongly support the concept of a uniform definition of qualified acquisitions. In addition, freed of the constraint referred to above, we believe that the continuity of interest requirement is unnecessary in a regime in which corporate-level taxation is based upon an explicit election and shareholder taxation turns upon whether stock is received in the transaction.

Although we generally support the uniform definition, we are troubled by its continuation of features to enforce a dubious principle that has come to be called the "consistency principle" -- consistency in the treatment of all assets acquired from a corporation in a given period of time as all being acquired in cost-basis acquisitions or in carryover-basis acquisitions. A lesson from the recent past explains our concern. Only three years ago Congress enacted Section 338, permitting a corporation which acquires the stock of another corporation to treat the transaction for tax purposes as an asset acquisition by making a simple election to that effect. Like the current proposals, this promised to be a great simplication of the law. But the election was literally riddled with exceptions and qualifications all aimed at preventing the acquisition of some assets with a stepped-up cost basis and others with a carryover basis. The rules to require such consistent treatment nearly doubled the size of the statutory provision, have already produced more than a hundred pages of regulations, and have caused a very large segment of the tax bar to regret that the measure was ever enacted.

The rationale for these consistency rules would be completely eliminated by the current proposals. Under the law in effect when section 338 was enacted, a corporation selling assets could avoid recognizing corporate-level gain on that sale even though the buyer obtained a stepped-up or cost basis as a result of the purchase. The statutory provisions permitting this result would be repealed by enacting the current proposals. Nonetheless, the proposals retain a substantial measure of the consistency rules found in Section 338. There is no convincing reason for this. The uniform definition of a qualified acquisition should be relaxed to permit some assets to be acquired with a cost basis as long as the seller is taxed thereon and other assets to be acquired with a carryover basis, in which case the buyer will pay the tax on any subsequent transaction that steps up the basis of those assets.

Repeal of General Utilities. Under current law a corporation holding assets with values substantially in excess of their tax basis can sell those assets for cash, the buyer can take the assets with a tax basis equal to his cost and the selling corporation does not pay tax on its gain. Exceptions to the selling corporation's freedom from tax exist for so-called recapture gains and items captured by the tax benefit principle. To qualify for absence of tax at the corporate level, the selling corporation need only liquidate, thereby generally triggering tax at the shareholder level.

The historical root exempting corporate-level gain in liquidations and in other circumstances, is General Utilities & Operating Co. v. Helvering.[6] At its broadest, that case stood for the proposition that a corporation should not recognize taxable gain upon the distribution of appreciated property to its stockholders in respect of their stock. Under the original articulation of this principle, distributions of appreciated property were not taxable to the distributing corporation if the distributions were in payment of dividends, for the redemption of shares, in partial liquidation, or in complete liquidation. Over the years Congress and the courts have narrowed the General Utilities principle so that the major effect of it today is the exemption from tax of distributions in complete liquidation.[7]

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[6] 296 U.S. 200 (1935)

The proposals call for complete repeal of these last vestiges of the General Utilities principle. They would fully tax a corporation on the appreciation in value of its assets when they are distributed in complete liquidation. If this were done without any form of relief, two levels of tax would be due upon complete liquidation of a corporation. The liquidating corporation would be taxed on appreciation in the assets distributed, and its shareholders would also be taxed on their receipt of the liquidating distribution.

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[7] Section 336. Section 337 also exempts taxation of gain on a sale in connection with complete liquidation of the selling corporation in recognition of the fact that the same result could be achieved by liquidating the corporation immediately before the sale of its assets.

Without question double taxation of liquidating distributions was perceived as the most controversial aspect of the proposals set forth in the Preliminary Report. Since the publication of that report the controversy surrounding this point has narrowed. At present the debate centers around what type of relief from this double tax burden is required to make the proposals generally acceptable. This is a large step in the gathering of a consensus in support of the proposals. In other words, the general impression has shifted from opposing taxation of liquidating distributions to accepting that basic premise but only if the tax burden, as compared with that under current law, is not seen as unfairly large.

The Final Report recognizes that relief from the double tax burden is appropriate and proposes two forms of relief from the full repeal of the _General Utilities_ principle. Under the proposals, gain in respect of capital assets held by the liquidating corporation for some time prior to the liquidation would not be subject to double taxation. We believe exempting gains on long-held capital assets from the double tax is essential to acceptance of these proposals. The concept of such relief was considered in the American Law Institute's Subchapter C proposals and in the Preliminary Report. As originally put forth, the result could be achieved by exempting liquidating corporations from tax on such gains or by taxing the corporations and allowing their shareholders a credit for the tax paid by the corporation.

The Final Report rejects the alternative of exempting the liquidating corporation from tax, and proposes to grant relief to its shareholders. The shareholder credit previously advanced as a means of doing so had been criticized as being too complicated. The Final Report responded to this criticism with a creative, new approach. Instead of a credit, the Final Report proposes that shareholders of the liquidating corporation increase the tax basis of their shares of the liquidating corporation by the amount of the after-tax gain realized by the liquidating corporation on account of long-held capital assets. The Final Report suggested that to the extent that Subchapter C reform legislation raises revenue, consideration should be given to reduction of the maximum corporate capital gains rate across the board. We concur in that suggestion, but would limit rate reduction to instances where the gain realized gives rise to relief at the shareholder level.

We believe the proposed basis adjustment is an appropriate means of dealing with the need for fairly simple form of relief from repeal of General Utilities. However, we strongly object to the proposal to limit this relief to small corporations. The relief should be available to all corporations. There is no reason to limit the relief to corporations of a given size.

We also suggest that the holding period for capital assets to qualify for this relief be three years. There is precedent for a three-year holding period elsewhere in the Internal Revenue Code. For example, the collapsible corporation provisions of Section 341 do not apply to assets held for more than three years. In addition, three years is long enough to insure that corporations will not acquire assets to take advantage of the relief, and short enough to make the relief meaningful.

"Shareholder Flavoring" Rule. The Final Report proposes a new statutory provision which would require a corporation to treat as ordinary income, gain on the sale of property that it had received from its shareholder, if the shareholder would have realized ordinary income had he sold the property. This "flavoring" applies to any property received by the corporation within three years of its disposition by the corporation.

The proposal is unnecessary and undercuts one of the benefits of the proposals as a whole. It is unnecessary because the imposition of corporate-level tax on liquidations and other dispositions provides a sufficient deterrent to collapsible activity, achieving much the same result as section 341(f) of current law. Moreover the Internal Revenue Service has ample authority to challenge abusive cases. This shareholder flavoring rule undercuts the simplicity otherwise achieved in the Final Report. We urge that it be dropped from the proposals.

Limitation on Net Operating Losses and Other Tax Attributes. I do not address an important matter on which Mr. Calkins has testified -- the limitation of net operating losses and other corporate attributes. We subscribe full to his testimony on this subject.

We urge that the Committee take action to introduce the Staff Report in bill form, that additional hearings be conducted, and that, with appropriate modification, the proposals be enacted. We would be pleased to work with the Committee staff toward these objectives.

Senator **Chafee**. Now, Mr. Calkins was speaking on behalf of the ABA Section of Taxation, but you are not; you are speaking on your own behalf, is that right?

Mr. **Aidinoff**. I am speaking on my own behalf.

Senator **Chafee**. Although you were associated with Mr. Calkins on the ABA Tax Section that studied this?

Mr. **Aidinoff**. I am a former chairman of the section of taxation. And as a former chairman, I was invited to be one of the group of practitioners who participated in the subchapter C study of the staff.

Senator **Chafee**. I see. But Mr. Calkins took no position on the general utilities, because he was speaking for the ABA.

Mr. **Aidinoff**. He is speaking for the ABA. I am speaking as an individual practitioner, on behalf of myself I think that some of my views are shared by a number of other practitioners who participated in the study.

Senator **Chafee**. All right. Thank you, Mr. Aidinoff.

Mr. Collinson.

STATEMENT OF DALE S. COLLINSON, CHAIRMAN, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, NEW YORK, NY, ACCOMPANIED BY HERBERT L. CAMP, SECRETARY, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, NEW YORK, NY

Mr. **Collinson**. My name is Dale Collinson. I am chairman of the tax section of the New York State Bar Association, and I appear here on its behalf. With me is Herbert Camp, who is secretary of the tax section.

At the outset of these hearings, Mr. Chairman, you noted the heavy representation of New York and Washington practitioners in the consulting group that worked with the staff in the development of these proposals. Many of the New York representatives and one of the Washington representatives are members of the executive committee of our tax section, and they have been very helpful in our own deliberations in arriving at the position that we take. We appreciate this opportunity to comment on the report.

Given the prior involvement of many of our members, it is perhaps not surprising that we generally support the acquisition and net-operating-loss-carryover proposals of the staff. We believe that they would simplify and make rational the law in that area, and that they would eliminate many of the needlessly complex technical obstacles that under present law can prevent taxpayers from realizing legitimate objectives.

I should also point out, however, that while a majority of the executive committee supports the recommendations that I will summarize, there is substantial sentiment in our committee not to make fundamental changes in subchapter C for the time being, and to suspend further work on the project. To some extent I think that reflects a general inability to keep pace with the very many and broad-ranging changes in the tax law that have occurred in 1981, 1982, and 1984.

We urge that Congress carefully and deliberately consider the issues presented by the proposals and that proposed legislation as it relates to mergers and acquisitions not be considered as part of an accelerated general tax reform package.

Now, with respect to the individual issues:

We support the proposal to allow elective cost or carryover-basis treatment of corporate acquisitions at the corporate level. We also support entity-by-entity consisentency rules, with the good-will exception, as being preferable to the group-wide approach in present law section 338.

We support the proposed separation of corporate and shareholder treatment and the repeal of the continuity of interest requirement.

We support the replacement of section 368 and its alphabet soup of merger and acquisition transactions with the new proposed section 364.

We support the complete repeal of general utilities; however, we support the giving of relief from the repeal of general utilities in a complete liquidation and disagree with the staff's proposal to limit relief to small business.

In addition, we would urge further consideration of an expanded section 333 type treatment for in-kind liquidations not constitutiing a step in a disposition. As respects the type of general relief in a liquidation situation, we support the shareholder basis adjustment as proposed by the staff.

Assuming that general utilities relief is confined to small businesses, we support the staff's proposed relief mechanism, subject to the recommendation for further consideration of alternate treatment of in-kind liquidations.

Now, with respect to the net operating loss proposal, generally we support the approach taken by the staff. I think everybody here has said that there is a lot of congruity between the ABA approach and the staff's approach and that the sameness in identity is more important than the differences. However, we, like others, believe that the use of the applicable Federal long-term rate in the earnout formula is incorrect, because it is too low, and that some equity-type return rate would be more appropriate.

Thank you, Mr. Chairman.

Senator CHAFEE. Thank you very much, Mr. Collinson.

Ms. Low.

[Mr. Collinson's written testimony follows:]

September 30, 1985

STATEMENT OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION

Subchapter C Revision Act of 1985

My name is Dale S. Collinson. I am the Chairman of the Tax Section of the New York State Bar Association and appear here on its behalf. With me is Herbert L. Camp, Secretary of the Tax Section.

The Tax Section has over 2,900 members, all of whom are lawyers with a professional interest in taxation. They include practicing lawyers, judges, professors of law, corporate counsel, and officials and employees of the Treasury Department and the Internal Revenue Service.

Members of the Tax Section have been among those who met regularly with the Senate Finance Committee Staff in its preparation of its preliminary proposals* and its final report,** and we appreciate this opportunity to comment on certain aspects of the Final Report.

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* The Reform and Simplification of the Income Taxation of Corporations, a Preliminary Report prepared by the Staff of the Senate Committee on Finance (September 22, 1983) (the "Preliminary Report").

** The Subchapter C Revision Act of 1985, a Final Report prepared by the Staff of the Senate Committee on Finance (May, 1985)(the "Final Report").

Our comments are organized around the specific questions on which comments were requested by the press release that announced this hearing*. We do not make technical comments in this presentation, since we believe that the primary focus of this hearing is the broad policy questions underlying the proposals.

As set forth in more detail below, we generally support the acqusition and net operating loss carryover proposals of the Staff. We believe that they would simplify and make rational the law in that area and that they would eliminate many of the needlessly complex technical obstacles that under present law can prevent taxpayers from realizing legitimate objectives. I should point out, however, that, while a majority of the Executive Committee of the Tax Section supports our recommendations set forth herein, there is substantial sentiment on the Committee not to make fundamental changes in Subchapter C for the time being, and to suspend further work on the project.

We urge that Congress carefully and deliberately consider the issues presented by the proposals in the Final Report, and that proposed legislation not be considered as part of an accelerated general tax reform package.

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* Press Release No. 85-056, July 17, 1985.

1. Elective cost or carryover basis acquisitions. As we have previously stated*, we support a straightforward election between cost and carryover basis in corporate acquisitions, making explicit a "check-in-box" to replace the "transactional election" presently available to well-counseled taxpayers (but not, unfortunately, to others).

The Final Report recommends an entity-by-entity consistency rule, with an exception for goodwill and certain other non-amortizable intangibles. We believe that the entity-by-entity approach (with the goodwill exception) is far preferable to the group-wide consistency rule of present-law section 338, but less preferable than an asset category consistency rule. As we previously stated**, the entity-by-entity rule will undoubtedly lead frequently to pre-acquisition asset tailoring that will result in the practical equivalent of mere asset, or asset-category, consistency. We believe it undesirable to encourage such complex and artificial pre-acquisition planning that will lead to structures in which assets will be assigned to different corporations without regard to whether the structures make business sense.

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* Letter of August 2, 1983, from Willard B. Taylor, then Chairman of the Tax Section, to Roderick A. DeArment, then Chief Counsel to the Committee on Finance.

** Id.

2. Separate corporate and shareholder consequences. We support the proposed separation of the shareholder-level tax consequences of a corporate acquisition from the corporate-level election and from the consequences to other shareholders. Specifically, a shareholder or security-holder should obtain "tax-free" treatment on the receipt of qualifying consideration in a qualified acquisition (a) even if the acquisition is a cost-basis one and (b) regardless of the extent of stock issued to other shareholders (*i.e.*, eliminating the "continuity of interest" requirement).

3. Uniform Definitional Structure. We support the repeal of section 368 and its replacement with proposed new section 364, defining a qualified acquisition. The reorganization categories of section 368 are inconsistent with each other and reflect no uniform policy as to what should or should not be a tax-free corporate acquisition; section 364 corrects those difficulties.

4. General Utilities. We agree with the Staff (see pages 59-62 of the Final Report) that repeal of *General Utilities* is essential to the implementation of the electivity and other proposals made by it (which we support) and that, apart from relief, discussed below, the repeal should be without exceptions.

5. Relief. (a) In General. We agree with the Staff that relief from the complete repeal of *General Utilities* should be confined to complete liquidations. We also believe that relief, if any, should be confined to long-held capital assets. We do not agree, however, that relief ought to be confined to "small businesses". The distinction between large and small businesses is at best blurred and we can see no good policy reason to prefer one over the other as to relief from *General Utilities*. That large corporations *might* be able to plan around the problem of repeal (see the Final Report at 63) should not be a reason to deny them relief; nor is the complexity of relief a reason to deny relief, especially since the large corporations might be better equipped to deal with any complexity.

(b) Form. For the reasons expressed by the Staff (Final Report, at 64-65), we support the use of a shareholder relief mechanism, specifically a basis adjustment to eliminate the double tax on 5-year capital assets.

We also believe, however, that the Staff should give further consideration to an alternative relief mechanism for in-kind liquidations, under which (1) the liquidating corporation would incur no *General Utilities* tax except on ordinary income assets, such as cash basis receivables in excess of payables, installment gains, recaptures, and tax-benefit items; and (2) each shareholder would recognize dividend income attributable to his share of earnings and profits accumulated during his holding period, and no other gain or loss, with a carryover of asset basis. Such "reverse section 351", or expanded section 333, treatment may well be a more appropriate solution for a true in-kind liquidation (i.e., where the assets are to be retained by the shareholders). While we agree with the Staff (Final Report at 66) that section 351 arguably serves a policy goal of facilitating incorporation, we also see a policy goal favoring a true in-kind liquidation.

6. Small Businesses. Assuming relief is confined to small businesses, as the Staff suggests, we support the Staff's recommended mechanism, subject to the suggestion in 5(b), above.

7. Tax Attribute Carryovers. I refer to the Tax Section's testimony (by Messrs. Robert Jacobs and Richard Loengard) before the House Ways and Means Committee on May 22, 1985.* A copy of that testimony is attached. As suggested therein, the Tax Section supports the neutrality approach,

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* See also our testimony before this Committee submitted October 24, 1983, following issuance of the Preliminary Report, and our testimony of September 22, 1983, before the Subcommittee on Select Revenue Matters, Committee on Ways and Means.

under which the post-acquisition use of tax losses and other attributes is limited to projected future earnings of the loss corporation (which presumably reflects the extent that it could have used them in absence of acquisition). Specifically, the Tax Section believes that:

(a) The Staff's proposal to adopt the ALI neutrality approach, using a single rule, is preferable to current law;

(b) That approach is preferable to the 1976 amendments, not yet effective;

(c) That approach is preferable to a separate rule for purchases and mergers;

(d) The applicable long-term federal rate as an assumed earn-out rate is too low;

(e) There should, in general, be no special rule for investment companies; an investment company might, however, be required to use the applicable federal long-term rate as an earn-out rate;

(f) Built-in gains and losses (including future depreciation) should be treated as proposed; and

(g) Section 269 should not disallow any loss or credit to which section 382 or 383, as amended, would apply; and the SRLY and CRCO rules of the consolidated return regulations should be repealed.

As to (d), the earn-out rate, we believe that the rate should be a reasonable equity-like rate of return. The applicable federal rate is a debt-rate, and is too low. The Final Report (page 71) starts from a Joint Committee on Taxation model that compares pre-tax, pre-NOL income to book value and then adopts the debt rate on the ground that a loss corporation could sell its assets and invest in long-term Treasury bonds to earn out loss carryforwards. The use of book value produces far too low a figure; book value bears no relationship to fair market value (to which the rate is to be applied) and in the case of a loss corporation will often be far higher than fair market value (resulting in built-in losses which would themselves be subject to limitation). We therefore suggest a rate which represents a reasonable pre-tax return on equity that a purchaser would expect, which is a rate in excess of the applicable federal long term rate.

We previously recommended, and we continue to recommend, that any new carryover rules embodying the neutrality principle be based on reasonable interest rate assumptions. As we stated in our May 1985 testimony, we strongly believe that the rate assumptions underlying the American Bar Association Tax Section's Legislative Recommendation 1985-1 (allowing 5 years of carryforwards at a rate of 24% of the purchase price) comport with business reality and are within the range of a correct result. Those rate assumptions are a 20% pre-tax earnings rate and a 10% discount rate.

As to (g), we believe that the SRLY and CRCO rules should be eliminated. The SRLY rules prevent the frustration of sections 382(a) and (b) through applying an acquired loss carryforward against post-acquisition income of other members of a consolidated group. Section 382 as revised contains a limitation based on the neutrality principle (what the loss corporation would have earned using a rate based on its purchase price) and there is no further limitation based on the size or earning capacity of the acquiror. A large acquiror, with large income, would be no worse off under new section 382 than would a smaller acquiror. In a consolidated return context, it would make no difference whether the acquiror were a single corporation with that large income, or a member of a consolidated group itself having small income, but where the group had large income.

The CRCO rules are designed to deal with earning out acquired loss carryovers with new member income where the new members are acquired with fresh capital contributed by shareholders. New section 382 contains comprehensive anti-abuse provisions concerning capital contributions. See the

Final Report at 248. Those provisions disregard (1) pre-acquisition contributions designed to increase the value of the loss corporation, and so the limitation, or to affect the 25% threshold level for built-in losses, and (2) contributions (presumably whether before or after acquisition) of appreciated property to eliminate built-in losses. Since there is no general post-acquisition rule against capital contributions to increase income to use up the losses, there should be none in the consolidated return context, and the CRCO rule should be abandoned.

May 22, 1985

STATEMENT
# of the NEW YORK STATE BAR ASSOCIATION TAX SECTION
CARRYOVER OF CORPORATE TAX ATTRIBUTES

We are Robert A. Jacobs and Richard O. Loengard, Jr., co-chairs of the Committee on Reorganizations of the New York State Bar Association Tax Section. We appear on behalf of the NYSBA Tax Section.

The Tax Section has over 2,800 members, all of whom are lawyers with a professional interest in taxation. The Tax Section is pleased to share with you its views on the proper means of dealing with the carryover of tax attributes in various corporate settings.

Several members of the Tax Section have participated over the past two and one-half years with staff members of various Congressional committees, Treasury Department and Internal Revenue Service officials and representatives from other professional organizations together with respected academics in examining, among other subjects, changes in the treatment of carryovers of tax attributes. In the course of those endeavors a consensus has emerged on a large number of the issues. Part of that emerging consensus is the proper treatment of tax attribute carryovers. We join with the other participants in this effort in urging the prompt enactment of a new Internal Revenue Code section 382 that would provide exclusive limitations for tax attribute carryovers following a change in control of the target corporation possessing those tax attributes. We further join in urging that utilization of those corporate tax attributes be limited to a percentage of the target corporation's value before the change in control -- a value generally measured by the purchase price of the target loss corporation.

The Tax Section believes that sections 382 and 383, as currently in effect (i.e., without giving effect to the 1976 amendments), are neither an effective nor a fair method of permitting appropriate utilization of carryovers in some transactions or of preventing perceived inappropriate trafficking in loss carryovers and other corporate tax attributes. To the extent the application of those sections in a purchase transaction turns on the continued conduct of a business, they may require continuation of uneconomic activities merely to preserve tax attributes. For example, under Treasury Regulations, a change in the location of the business may cause the loss of all tax attributes. Conversely, if the business is continued, all corporate tax attributes may be preserved regardless of the relative value of the business and those attributes. The Tax Section believes, further, that the other principal statutory provision that may be applicable in these transactions, section 269, is often random in operation, unfairly penalizing some transactions and leaving unaffected other transactions that should be subject to tax attribute reductions. As such, it improperly introduces a speculative factor in the pricing of business acquisitions, resulting in windfalls or losses depending upon unpredictable audit and litigation results.

"New section 382," i.e., the 1976 version, is ill suited to the problem. While it would double the length of present Code section 382 and provide a minefield of interpretative problems, complexity and uncertainty,* it would also deny all net operating loss carryforwards or other attributes where all the stock of the target has been purchased. Denial would occur -- merely by reason of a change in control -- even as to attributes that the target could reasonably be expected to have utilized had it not been purchased.

While a substantial minority of the Tax Section Executive Committee believes changes in section 382 should be delayed until the tax reform proposals presently being discussed have been considered and acted upon, the majority of the Committee believes the proper resolution of the tax attribute carryover problem is now to embrace the "neutrality" principle enunciated by the American Law Institute ("ALI") in its 1982 report. That principle is embodied in the American Bar Association Tax Section's Legislative Recommendation 1985-1 (the "ABA Draft"), and while we do not suggest that the precise formulation of the ABA Draft (allowing 5 years of carryforwards at a rate of 24% of the purchase price) is the only correct result, we do believe that a purchase price limitation equating on a discounted present value basis to a high percentage of the purchase price is appropriate.

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* See New York State Bar Association, Tax Section, "Report on Section 382 of the Internal Revenue Code as amended by the Tax Reform Act of 1976," 31 Tax Lawyer 283, 284 (1978).

The key to applying the neutrality principle is approximating and preserving the value of the tax attributes as they exist in the hands of the seller -- without enhancement or diminution -- in the hands of the buyer. In other words, the favorable tax attributes available to the buyer should equal those attributes available to the seller. In practice, that equality may be difficult to achieve, but it should be sought and effected wherever possible. The ABA Draft seeks that result and approximates it in most cases. In some cases, the ALI or Senate Finance Committee Staff would achieve these results -- with greater or lesser equity -- by applying somehwat different formulae. Under a neutrality-principled statute, tax attributes may be transferred, provided the transfer is incident to an acquisition of income-producing assets, i.e., part of a corporate acquisition. Adopting the neutrality principle would not permit the mere trafficking in loss carryovers, but in appropriate cases would enable a loss corporation to transfer freely its beneficial tax attributes as part of an overall change in its control. Properly structured and applied, a statute based on the neutrality principle would provide sellers with fair compensation for the tax attributes transferred by them to buyers, prevent buyers from obtaining tax attribute windfalls and leave the Treasury Department neither enhanced nor diminished by tax attribute transfers.

The ABA Draft implements these principles, utilizing a single purchase price rule to establish the amount and rate at which tax attributes may be utilized following a change in control of the target corporation.* As mentioned, the ABA Draft uses a five-year period and a rate of 24% of the purchase price. You should note that the 24% assumes a 10% discount rate and a 20% pre-tax earnings rate, as well as a five year earn-out, and that if those assumptions are changed, the result changes. We believe that the ABA Draft's rate assumptions comport with business reality and are within the range of a correct result. We support the ABA Draft's approach to achieving tax neutrality.

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* The ALI version of "neutrality" contained a different method for ascertaining the available NOLs after reorganizations. In a simple case, a corporation, with only common stock outstanding, acquires, solely for common stock, another corporation. If either corporation has an NOL, the combined company can use a percentage of the NOL, the percentage depending on the percent of stock of the combined companies held by the loss company's former shareholders. While this proposal avoids the need to value the stock in question, it does not apply to purchase acquisitions, nor is it easily applied when complex corporate structures, or transactions, are involved. We favor a single rule that can be generally applied to all types of transactions -- all stock, all cash and part stock, part cash.

On September 22, 1983, our Tax Section testified before this Subcommittee suggesting "that the Committee carefully consider the possibility of a single limitation measured by the purchase price for the loss corporation itself." We noted that under that approach, it would be impossible for an acquiring corporation to profit from the purchase of tax losses, because the tax benefit from the tax loss is always a lesser amount then the loss itself. We observed that adopting a single purchase rule for all transactions would avoid complexity. On October 24, 1983 in a hearing before the Committee on Finance, United States Senate, then Tax Section chairman, Willard B. Taylor, testified that a single purchase rule for section 382 could either limit carryovers to an interest-like return on the purchase price or to a lump sum amount. The ABA Draft provides a simple gross up of the purchase price to 120% of the purchase price and then spreads its utilization over 60 months following a change in corporate control. We believe this a rational application of the neutrality principle, properly balancing the theoretical application of the principle with business realities. The 60-month utilization balances the need not to unduly favor large potential acquirors over smaller ones with a realistic view of the time span businesses look to recover their investments in purchased tax attributes.

Under the neutrality principle, it would make no difference whether the target loss corporation had all active business assets or all passive investment assets. The only question is the ability of the target corporation to earn income from its assets against which the favorable tax attribute may be applied. We recognize that you may seek to limit the carryover of tax attributes to cases where a stipulated portion of the target's assets are business assets. If you do so decide, we believe the relevant measuring date should be the date on which a binding contract is entered into and that no requirement be expressed or implied as to the length of time the business assets must have been held by the target or retained by the purchaser.

Many corporations -- especially small corporations -- are capitalized with both debt and equity. Where the debt is "old and cold" we believe it should be treated as part of the purchase price, if the debt is converted into equity either before the change in control or promptly thereafter. This again is merely an application of the neutrality principle, placing the buyer in the same position as the seller.

One of the principal goals of any remedial legislation in this complex area should be certainty. Here we join the Senate Finance Committee Staff and the ABA in urging that the section 382 rules operate exclusively in this area. Section 269 should not apply whenever a transaction is governed by section 382.

In drafting any amendments to section 382, care must be taken to assure appropriate treatment for insolvent target corporations that undergo reorganizations either under the bankruptcy laws (title 11) or pursuant to informal arrangements. Special care must also be given to acquisitions of troubled thrift institutions.

We recognize that reasonable people can differ as to the best means of effecting the neutrality principle. Were we to attempt to draft a statute embodying that principle, we might make some decisions different from those made in the ABA Draft. No doubt you and your staff could devise statutory language embodying that principle that would differ materially from the ABA Draft version. But we do not believe any noble cause would be served by starting anew. The ABA Draft is a thoughtful and comprehensive approach to the tax attribute carryover problem. We join the ABA in urging you to use its draft to formulate your legislation, thus measurably reducing the risk of unforseen problems and unintended results. We shall be pleased to work with you and your staff in developing this legislation. We are pleased to join with you in this effort to end -- at last -- the long period of uncertainty as to how tax attributes should be treated in corporate acquisitive transactions. Finally, we note that this testimony addresses tax attribute carryovers in our present corporate tax environment. If major tax reform proposals are enacted, a somewhat different provision may be more appropriate.

STATEMENT OF EVELYN LOW, VICE CHAIR, TAXATION SECTION, STATE BAR OF CALIFORNIA, SAN FRANCISCO, CA

Ms. Low. Thank you.

I am Evelyn Low, a member of the Executive Committee of the Section of Taxation of the State Bar of California—yes, indeed, the west coast—and chairman of that section's Committee on Corporate Tax. I am here on my section's behalf.

We are pleased to have an opportunity to comment on the staff's significant efforts toward the reform of subchapter C. Since we generally support the proposals relating to corporate acquisitions, my testimony today will emphasize those areas with which we are most concerned: the repeal of general utilities, and the proposals regarding net operating loss limitations.

With respect to general utilities, we recognize the necessity for amending the doctrine in the case of acquisitions; however, we oppose the repeal of general utilities where it will impose a double tax on appreciated capital assets sold or distributed in the course of a liquidation not part of a qualified acquisition.

Under current law, no gain or loss is recognized by the corporation upon distribution or sale of appreciated assets as part of its liquidations. Exceptions to these nonrecognition rules effectively eliminate most bailout potential of ordinary income at cap gain rates. Thus, under the current rules, the shareholder pays a single cap gain tax on the receipt of capital assets and a double tax is imposed with respect to ordinary income assets. An extension of the double tax rule to the liquidating corporation's remaining capital assets would more than double the cap gain rate on these assets and would reverse longstanding tax policy which we believe continues to be fair and sensible.

The reasons given by the staff for the repeal of general utilities are not persuasive in the case of a liquidation. We do not share the staff's concern that the general utilities rules create a tremendous pressure in favor of liquidations. We believe that the current exceptions to general utilities adequately deters most tax-motivated liquidations. Indeed, the repeal of general utilities with respect to liquidation cuts against the staff's overall objective to make the tax law more neutral by placing corporations at a tax disadvantage. The bias created against corporate form would most certainly result in hardship to existing corporations and an undesirable decrease in corporate formation where, absent tax consideration, the corporate form would be preferable.

If general utilities were repealed, we recommend any relief that eliminates the effect of double tax in the case of a liquidating distribution of capital assets, provided the liquidation is not part of an acquisition, or a cost-basis election has been made. This relief should take the form of a corporate-level exception or a shareholder credit and would not be limited to small businesses.

We believe that the staff-proposed relief measures do not adequately relieve the hardship created by the imposition of the double tax on the sale or distribution of a corporation's capital assets at the time of liquidation.

Under the proposals, permanent relief is available only to shareholders of small corporations, which is generally $1 million or less at the date of the transaction. Assuming that this relief should be limited to small corporations, we believe that the $1 million fair-market-value test fails to take into account the tremendous inflation of the past decade and, consequently, we would recommend that a higher cutoff amount be considered.

We support the simplification of code section 333 and its use as a relief measure; however, we prefer the permanent relief measures previously described over the staff shareholder deferral measure.

To adequately meet an existing corporation's and its shareholders' expectations, we would also support a liberal transitional rule.

With regard to net operating losses, we prefer the 54 net-operating-loss limitation rules coupled with 269 over the staff proposals; however, if pressure for a new net-operating-loss limitation makes its enactment inevitable, we would prefer the 76 version of code section 382 to tbe staff's proposals.

We would prefer the 76 rules primarily because they contain a phase-in of the NOL limitation rule for changes of ownership between 60 and 100 percent. The proposals provide that the same limitations be imposed whether there is a 51-percent change or a 100-percent change. This all or nothing approach puts an undue amount of pressure on very technical rules.

Assuming that the single-purchase rule is to be adopted, we believe that the formula limitation based upon the product of the Federal long-term rate and the value of the loss corporation stock should be modified in two ways: First, in order to adequately reflect the added risk associated with the retention of the assets in a business, we recommend a higher rate than the Federal long-term be adopted; and to add certainty to the calculation of the limitation, we suggest that stock purchase price with adjustments be substituted for value of loss corporation stock.

That concludes my testimony. Thank you.

Senator CHAFEE. Thank you, Ms. Low.

[Ms. Low's written testimony follows:]

STATEMENT OF
EVELYN A. LOW

I am Evelyn Low, a member of the Executive Committee of the Section of Taxation of the State Bar of California and Chairman of the Section's Committee on Corporate Taxation. The comments contained in this Section's statement and my testimony represent the views of the Tax Section and do not represent the State Bar of California as a whole.

The Tax Section has previously submitted written comments to the Senate Finance Committee's Preliminary Report on The Reform and Simplification of Income Taxation of Corporations.* We are pleased to have an opportunity to comment on the Staff's final report on The Subchapter C Revision Act of 1985, submitted in May, 1985.

These comments will address the following topics, corporate acquisitions, repeal of the _General_ _Utilities_ doctrine and limitation on net operating losses, as requested in the press release announcing this hearing.

Corporate _Acquisitions_

We enthusiastically support the Staff's recommendation to make corporate level tax consequences of a qualified acquisition explicitly elective, thereby making available to all taxpayers an election which in fact is presently exercised by the well-advised taxpayer. With respect to shareholder consequences, we approve of the separation of tax consequences of the shareholder from the corporation which allows a shareholder to receive nonrecognition treatment when the shareholder receives qualifying consideration despite the form of the transaction or the tax consequences to the other shareholders. In the case of "boot," we also agree that dividend equivalency ought to be tested by reference to the shareholders' interest in the acquiring corporation following the acquisition. This rule adds certainty to an area where the Treasury and the courts have reached different results.

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*By letter of February 8, 1984, to Roderick DeArment, Chief Counsel of the Senate Finance Committee.

While we commend the Staff's endeavor to add certainty to the acquisitions area by providing specific statutory definitions relating to a "qualified acquisition" and eliminating the uncertainty created by the less precise requirements such as continuity of interest, we are concerned that the Staff's interpretation of a "qualified asset acquisition" is unnecessarily restrictive. Under the proposals, a "qualified acquisition" is either a qualified stock acquisition or a qualified asset acquisition. A "qualified asset acquisition" includes any transaction in which one corporation acquires at least 70 percent of the gross fair market value and 90 percent of the net fair market value of the assets of another corporation. The Staff Report states that the acquisition of the requisite percentage of the target corporation's assets must be acquired in a "single transaction" which may extend over several days--implying that an acquisition that requires more than several days would fall outside the qualified asset acquisition definition. Limiting a time frame with the term "several days" fails to provide adequate taxpayer guidance. While we agree that assets should be acquired in a single transaction, we do not believe that the asset acquisition must be accomplished within a few days. Such a rule will cause uncertainty in those transactions where all the contemplated assets cannot be transferred simultaneously. We recommend that assets which are identified as part of a preexisting plan or agreement to acquire assets be included in determining whether the 70/90 test has been met.

General Utilities

A. Complete repeal of General Utilities

If the acquisitions proposals are enacted, we recognize the necessity for amending the General Utilities doctrine, as codified by Code Sections 311, 336 and 337, in this area. However, we oppose the repeal of General Utilities where it will impose a double tax on appreciated capital assets which are sold or distributed in the course of a liquidation not part of a qualified acquisition. Under current law, no gain or loss is recognized by the corporation upon distribution or sale of appreciated property as part of its liquidation. Exceptions to these nonrecognition rules effectively eliminate most bail-out potential of ordinary business income at capital gains rates. Thus, under the current rules a shareholder pays a single capital gains tax on the receipt of capital assets, and a double tax is imposed with respect to ordinary income assets.

An extension of the double tax rule to the liquidating corporation's remaining capital assets would increase the capital gains rate on these assets from 20% to 42.4% and would reverse long-standing tax policy which continues to be fair and sensible.

The reasons given by the Staff for the repeal of General Utilities are not persuasive in the case of a liquidation. The

Staff's first concern is that the repeal of General Utilities is "essential to the implementation of the other proposals." It specifically is concerned that corporate parties to a "qualified acquisition" could elect to step-up the bases of the acquired assets without any recognition of gain if Code Section 337 remained in effect. This concern can be addressed without full repeal by simply excepting the operation of Code Sections 336 and 337 where a liquidation is part of a "qualified acquisition" and a cost basis election is made. Its second concern is that the General Utilities rule creates a "tremendous pressure in favor of certain types of transactions." We believe that the current exceptions adequately deter most tax-motivated liquidations. Indeed, the repeal of General Utilities with respect to liquidations would place corporations at a tax disadvantage and therefore cuts against the Staff's overall objective to make the tax law more neutral. The bias created against corporate form would most certainly result in hardship to existing corporations and an undesirable decrease in corporate formation where, absent tax considerations, corporate form would be preferable.

The Staff's third reason for the complete repeal of General Utilities is the concern that the rule lacks symmetry. We agree that there is a lack of symmetry where, as part of a reorganization, corporations can retain assets in corporate solution and yet be entitled to obtain a step-up in basis on those same assets. Where a liquidation occurs as part of a qualified acquisition, this result is avoided if, as suggested above, Code Sections 336 and 337 do not operate. There is no lack of symmetry in other liquidations where a shareholder exchanges his stock for corporate assets. Like all other sales and exchanges under the tax law, the shareholder recognizes gain or loss based upon the difference between the fair market value of the assets received and the adjusted basis of his stock. Having recognized the gain or loss, he is entitled to a step-up in basis.

B. Relief provisions

If General Utilities were repealed, we recommend any relief that eliminates the effect of double tax in the case of the liquidating distribution of capital assets, provided the liquidation is not part of an acquisition. This relief could take the form of a corporate level exemption for such liquidating distributions, or alternatively, a shareholder credit in an amount equal to the tax paid at the corporate level.

The Staff has proposed several provisions which do not adequately relieve the hardship created by the imposition of a double tax upon the sale or distribution of a corporation's capital assets at the time of liquidation. Under the proposals, shareholder relief is provided for shareholders of small corporations--worth $1 million (and decreasing relief for corporations worth up to $2 million) at the date of the transaction. Each shareholder may elect a basis adjustment in his stock in the liquidating small corporation to reflect corporate level recognized gain. Assuming that this relief should be limited to small corporations, the $1 million fair market value test overlooks the tremendous inflation of the past decade. Consequently, we recommend that a much higher cutoff amount be considered. The Staff chose the $1 million test because of its similiarity to other sections of the Code, most notably Code Section 1244. The reliance upon Code Section 1244 is inappropriate in this case. Under Code Section 1244, the $1 million cutoff mark is measured by the adjusted basis of assets contributed and does not include unrealized appreciation which is included in the Staff's fair market value rule. Moreover, the small corporation relief proposal fails to completely eliminate the hardship created by the repeal of General Utilities where such relief is justified. Under current law, a shareholder pays a single capital gains tax of 20% or less on the distribution of appreciated capital assets. From a policy standpoint, this is appealing because it results in the same tax effect as a sale of those assets by a partnership or proprietorship. Although the proposals also result in a single capital gains tax to be paid, it is determined at the higher corporate level capital gains rate of 28%. To achieve true neutrality for shareholders of small corporations, the corporate capital gains rate must either be reduced to 20%, or the shareholder be given a dollar-for-dollar credit for the tax paid at the corporate level.

The proposals also provide relief for an in-kind liquidation by providing deferral of shareholder level gain under rules similiar to current Code Section 333. To obtain deferral, the shareholder takes a basis in the corporate assets received equal to the basis in his stock given up. While we agree that relief should be provided in the case of an in-kind liquidation, we support permanent relief measures as previously described over the Staff's shareholder-deferral measure.

Finally, the Staff provides transitional relief in the form of a deferred effective date by stating that the bill will not be effective any earlier than January 1, 1986. This relief would be meaningless to many corporations which, for business purposes, are unable to liquidate during a deferral period--be it 3 months or 3 years. We support a grandfather rule that allows current law to govern recognition of gain or loss attributable to assets acquired prior to the enactment of the bill which are sold or distributed as part of a liquidation not part of a qualified acquisition.

Net Operating Loss

We generally believe that a corporation's loss should be transferable, subject only to the current rules of Code Sections 382 and 269. However, if pressure for a new net operating loss ("NOL") limitation rule makes its enactment inevitable, we prefer the 1976 version of Code Section 382 rules to the Staff's proposals. Under the 1976 rules, the threshold change in ownership that triggers the NOL limitation rules is 60% compared to 50% under the proposals. The higher threshold amount is preferable because it recognizes the business reality that shareholders quite frequently lose control of their corporations in order to encourage the infusion of new capital required to turn a business around. The 1976 rules are also preferable because they contain a phase-in of the NOL limitations rule for changes of ownership between 60 and 100%. The proposals provide that the same limitation be imposed whether there is a 51% change or 100% change. This all-or-nothing approach puts an undue amount of pressure on very technical rules and excessively interferes with business decisions.

It is requested that we comment as to whether the Staff's single purchase proposal is preferable to the so-called "two-rule" approach (i.e., a separate rule for "mergers" and for "purchases"). The Staff's stated objective of an NOL limitations rule is to limit NOL carryovers to an amount that the loss corporation would have utilized the loss had no change occurred. Since the same objective applies to both merger acquisitions and purchases, we would favor a single rule over the two-rule approach. We further favor a single purchase rule over a single merger rule because of its simplicity.

Assuming that a single "purchase" rule is to be adopted, we recommend the following changes to the proposed limitation formula. The proposal limits the extent that an NOL carryover may be used in any given year to an amount equal to the Federal long-term rate under Code Section 1274(d) multiplied by the value of the loss corporation stock immediately before the change. The Staff's reasoning is that a loss corporation would attempt to maximize utilization of its loss carryover by investing its remaining assets in investments similiar to long-term government bonds. We believe that the Code Section 1274(d) rate-of-return is too low. Assets are not generally sold and reinvested in conservative investments, but remain as part of an on-going business, which, by its nature, is considerably more speculative than an investment in long-term bonds. The rate-of-return should be higher to properly reflect the additional risk and comport with business reality.

The proposed limitation rule is intended to be applied objectively and result in greater certainty for taxpayers. However the use of value of the loss corporation stock as part of the limitation formula creates its own uncertainty since the Internal Revenue Service is not bound by a taxpayer's calculation of value. We recommend that the stock purchase price be used in place of value. For this purpose, the stock purchase price should be grossed up and adjusted for liabilities and other relevant items as similarly provided in Code Section 338.

We believe that the Staff's proposed limitations on the use of net operating losses is too broad. However, if the Staff proposals are enacted, we recommend the repeal of Code Section 269, which would then serve no significant purpose. We would further recommend that the Secretary be directed to amend the special limitations contained in the consolidated return regulations, including SRLY and CRCO rules, based on principles similar to the principles which apply in the case of the net operating loss limitations rules.

Senator CHAFEE. Mr. Jacobs, do you have any statement here? You are on a later panel, aren't you?

Mr. JACOBS. I will wait, thank you.

Senator CHAFEE. All right, fine.

Ms. Low, you are a little bit out of step with the others on the net operating loss.

Ms. LOW. Yes, I realize that.

Senator CHAFEE. Was it a close call?

Ms. LOW. Well, actually, I polled practitioners throughout my State, to feel what their feelings were in this particular area. They have been living with these rules for such a long time that they feel they are predictable, and they don't need the objectivity of a single, more rigid rule to effect business transactions of their clients, and that 382 and 269 currently provide adequate safeguards. They also, perhaps, feel that lost assets—some of them feel that the transferability of lost corporation loss is desirable in some instances where the abuse is not as prevalent; well, there is no abuse.

Senator CHAFEE. What do you say, Mr. Collinson, about Ms. Low's proposal that she is opposed to the repeal of General Utilities in the case of a liquidation which isn't part of a corporate acquisition?

Mr. COLLINSON. Our position is that it should be repealed, but that there should be a relief mechanism that applies across the board, and not limit it to small business, and that the basis adjustment proposed by the staff is appropriate.

Senator CHAFEE. I was interested in Mr. Calkins' point about "don't confine the net operating losses to section 11 alone, but to all workouts—other workout situations." What do you think of that?

Mr. COLLINSON. Well, I think Ron Pearlman also made a point about that, and there is a point to not pushing people into filing formal chapter 11 in order to qualify for something.

Senator CHAFEE. That seems to make some sense.

Mr. COLLINSON. Yes.

Senator CHAFEE. Mr. Aidinoff, did you comment on that.? I am not sure—do you agree with that?

Mr. AIDINOFF. I am in complete agreement on that; there is no reason why the provisions be limited to the technical title 11 bankruptcy situation.

Senator CHAFEE. Ms. Low?

Ms. LOW. Yes, we would be in agreement as well.

Senator CHAFEE. One of the witnesses after you, Mr. Aidinoff, is going to recommend scrapping the staff proposals and making certain modifications along the lines of the 1981 tax section recommendations. Are you familiar with those?

Mr. AIDINOFF. Yes, I am, sir.

Senator CHAFEE. What is your reaction to that?

Mr. AIDINOFF. The 1981 Tax Section recommendation was just a modification of the definition of "reorganization" so as to eliminate some of the dissimilarities among A, B, and C reorganizations, and to eliminate some of the uncertainty with respect to the application of the continuity of interest doctrine. It really was a very narrow proposal and is probably the type of proposal which could have been enacted without any difficulty and without much disagreement.

The problem with the proposal is that it doesn't deal with the broad acquisition area. We now have had an opportunity for several years to study the broad acquisition area, and the proposals that are made by the staff study which grow out of the ALI study, look at the whole area and make proposals which make overall sense, in my judgment, in the entire corporate-acquisition area. It is not that the 1981 recommendation is wrong; it is just that it deals with such a narrow portion of the acquisition area. We have gone way beyond that. We have done much more work, and we ought to take advantage of it.

Senator CHAFEE. OK.

Mr. Calkins, it seemed to me in your testimony you were saying that, while there are differences between what the ABA wants and what the staff recommended on the net operating losses, they weren't of such major significance they couldn't be worked out. In other words, you would take what the staff proposed, even though you would prefer your own.

Mr. CALKINS. That is correct, Senator.

Senator CHAFEE. Let me just ask a question of the panelists here. It seems to me that with regard to the application of the general utilities doctrine as it currently applies to liquidations, I would think the shareholders would think that was splendid. Aren't they very happy with that?

Mr. Aidinoff?

Mr. AIDINOFF. Oh, I think shareholders are very happy with it. I think corporations that take advantage of 337 are very happy with it.

I think the question is whether it is right, as a matter of tax policy.

Senator CHAFEE. But any time people are making money on something, pretty soon there is a very logical reason why it is right; at least, that is the experience we have had in this area.

Mr. AIDINOFF. Well, on that assumption we would eliminate all taxes completely.

Senator CHAFEE. Well, we have nearly come to that. But usually it is only for the areas they are concerned with and "keep the Tax Code as it exists for others."

In other words, obviously we are going to have some powerful arguments here, I would expect, on why it is splendid the way the system is working. Maybe the Government doesn't make out very well, but usually, "these things are encouraging investment, producing capital, or keeping the country functioning." There are usually a zillion reasons why it is "good for the Nation" for some people to get very rich.

Mr. AIDINOFF. Well, over the last 10 years, basically, many of the aspects of general utilities have been eliminated, and there has been a sort of basic recognition that at the corporate level any built-in appreciation ought to be taxed at the time that it goes out of corporate solution.

I think most of us recognize that the double tax problem is an important problem which has to be considered, and that's why I think many of us believe that the basis adjustment is an appropriate method of dealing with the problem. It is not as good as complete elimination of the tax in the view of those who would like to retain the general utilities doctrine; but, in essence, who gets the benefit of general utilities really is dependent on who is lucky enough to have appreciated assets. There is no real support in tax policy for eliminating that aspect of the corporate tax.

Mr. **COLLINSON**. Well, what you are alluding to, I think, is that there are a lot of people out there with family businesses where the stock is held by a principal stockholder, and he dies, and they have a wonderful situation which is that they can adopt a plan of liquidation, the company can sell its assets for cash, the cash can be distributed to the heirs. And since they have a stepped-up basis in Dad's stock, the whole thing is tax-free except for the estate tax.

Now, there are a lot of people who know about that out there and who are going to come up here and knock on your door once it gets generally known that that sort of thing is going to change, because it potentially affects the value, to them, of that very important asset in their family.

What we are saying is, as a matter of tax policy, that that rule that has been there is wrong. But it is very important to have a relief mechanism, partially in order to deal with the political realities of those situations, and that is going to be very controversial.

Senator **CHAFEE**. Well, you are right.

Thank you all very much for coming. I appreciate it.

Now if the next panel will come forward—Mr. Cohen, Mr. Faber, Mr. Roche, and Mr. Thompson. [Pause.]

Senator **CHAFEE**. Mr. Cohen, we welcome you once again and look forward to your testimony.

STATEMENT OF EDWIN S. COHEN, PARTNER, COVINGTON AND BURLING, WASHINGTON, DC, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. **COHEN**. Thank you, Mr. Chairman.

My name is Edwin S. Cohen. I am a member of the taxation committee of the Chamber of Commerce of the United States, on whose behalf I appear today. I am a member of the law firm of Covington and Burling of Washington.

Perhaps, in view of the number of distinguished professors who are speaking today, I should add that for many years I have also been a professor at the University of Virginia Law School and have labored in this field for a long time.

Senator **CHAFEE**. I want to say about the professors, every one of them stayed meticulously within the time limit, and I thought they were all geared for 50 minutes. [Laughter.]

But they did an excellent job.

Mr. **COHEN**. I hope I can do that, Mr. Chairman, but most of them are from the North, and I speak with a southern drawl, which may handicap me. [Laughter.]

In our written statement, we commend the staff for its dedicated and able work in a most difficult area of the tax law. With deep respect, however, we do express grave concern about certain aspects of the report and the draft statute.

We are concerned that portions of the proposal would seriously harm many small incorporated businesses that own appreciated property, particularly land and buildings, at the time the business is sold and liquidated.

Speaking generally, under present law, the businessman who retires and sells out after operating his business for 30 or 40 years can do so on payment of a capital gains tax with a maximum of 20 percent. And this is true today, whether there is a business that is incorporated or unincorporated.

The staff proposal for repeal of the General Utilities rule would not change this result if the business is not incorporated; but if the business happens to be incorporated, as is often the case, the staff proposal would require two capital gains taxes to be paid—one by the corporation and another by the shareholder—resulting in a tax of more than 42 percent, as contrasted with a tax of 20 percent if the business is not incorporated. The tax would be twice as large just because the business happened to be incorporated.

We respectfully urge that such a result would be harsh and inequitable and we think undesirable. We believe the committee should take a long, hard look at this proposal before imposing it upon the many incorporated businesses throughout the country, especially as it would fall on businesses in the small towns and the farming districts of the nation. Incorporation of business is frequently desirable, indeed often essential as a means of raising capital, ensuring centralized management, protecting against death of the shareholders, or other contingencies.

The chamber respectfully submits that the double tax proposal would impose an unfortunate burden on the widespread use of corporations as a means of conducting business, especially for smaller enterprises.

Recognizing the adverse effect a double tax would impose on these smaller incorporated businesses, the staff proposal includes a measure of relief for them, but we believe the relief is inadequate.

For example, first, the tax would, in any event, be raised from the present 20 percent to 28 percent, because it would impose the corporate capital gains tax of 28 percent and give relief only against the 20-percent individual tax.

Second, as was pointed out earlier, if the shareholder has died and the business is sold by the executors or his heirs, there is no capital gains tax under existing law, whether the business is incorporated or unincorporated. But under the proposal, if it is incorporated, there would be a 28-percent corporate tax.

Third, the relief would be limited to assets held for more than 5 years, causing unnecessary complications.

And finally, as has been pointed out, it would be confined to businesses having assets with less than $1 million.

Now, the staff proposal would permit a safety valve. It would permit the double tax to be avoided if the corporation sells its assets to another corporation and the purchasing corporation agrees to use for tax purposes the low tax basis that the selling corporation has. In other words, if the two corporations agree that the buyer will take over the seller's tax basis, then the double tax will be eliminated. By agreement of the parties, the tax would be deferred. And if the buying corporation is one that has operating losses or has assets that have depreciated in value and which could be sold at a loss, it is going to be utterly immaterial to the buying corporation whether or not it has a new basis or elects to take over the tax basis of the selling corporation. I think the result of this will be that there will be advertisements in the newspaper by those who want to avoid the double tax, seeking to find loss corporations who would buy them, and advertisements by loss corporations seeking these situations to acquire. And we do not think this is a desirable spectacle for the tax system or for American business.

Mr. Chairman, may I add that we urge that the committee give the staff's double-tax proposal the most thorough review for its broad effect on the present method of conducting incorporated business, especially for smaller corporations, and that you not act upon them until there is time for a thorough public analysis, not just by the lawyers, the professors, the economists, and the accountants who are here today, but by the business men and women who will bear the brunt of these proposals.

Thank you, Mr. Chairman.

Senator CHAFEE. All right. Thank you very much, Mr. Cohen.

Mr. Faber.

[Mr. Cohen's written testimony follows:]

STATEMENT
on
SENATE FINANCE COMMITTEE STAFF PROPOSALS
for
REVISION OF SUBCHAPTER C
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Edwin S. Cohen
September 30, 1985

My name is Edwin S. Cohen. I am a member of the Taxation Committee of the Chamber of Commerce of the United States, on whose behalf I appear today. I am a member of the law firm of Covington & Burling, of Washington, D.C. Accompanying me are Rachelle B. Bernstein, Manager of the Tax Policy Center of the Chamber, and Deborah Aiken, its Senior Tax Counsel.

The Final Report of the Committee Staff for revision of the corporate tax structure represents a thorough analysis of a most difficult area of the federal tax law. We sincerely commend the staff for its dedication and for the quality of its work.

Because of the many different types of transactions that can occur between two or more corporations, and between corporations and their shareholders and security holders, this 250 page document requires most careful study and analysis in order to judge its impact on the nation's business and upon the federal tax structure. The subject is extremely intricate and is of utmost importance to the method of conducting business in the United States. The Staff proposals would make extensive changes in the fabric of the corporate tax provisions. Many of the proposed changes seem quite desirable. Others we think require modification and further work and debate before changes of this magnitude are adopted.

When we testified before the Committee two years ago regarding the preliminary report of the Committee Staff, we stated that our study of the proposed new set of rules relating to sale or liquidation of incorporated businesses "leads us to voice most serious reservations as to their effect, especially on small closely held corporations." We expressed concern that the proposals would discourage and hamper the use of corporations as a means of conducting business, because under the proposals, on the eventual winding up of the incorporated business by sale or liquidation, either a double tax would be incurred on appreciated capital assets or a purchaser would pay less than fair market value for those assets. We noted our concern particularly for those businesses that are already incorporated and cannot now change to an unincorporated form of business without incurring substantial tax.

In its Final Report the Staff has included provisions to ameliorate the adverse effect of the proposed double tax on corporations of relatively small value with respect to certain assets under certain limited conditions. While the Chamber appreciates that in those limited circumstances, the Final Report would grant a measure of relief, we do not believe that the relief is adequate or that the double tax proposals should be adopted in their present form.

In our statement two years ago, we used a simple example to illustrate the Chamber's concern, and that same example can be used again:

> Individual A opens a drug store and buys for $10,000 the land and building in which the store operates. Thirty years later he retires and sells the business, including the land and building, which are now worth $110,000.
>
> If A has operated the business individually, without incorporation, he has a long-term capital gain of $100,000 on the

sale of the land and building, on which he pays a maximum tax of $20,000 under existing law.[1]

If under existing law he had operated the business as a corporation, he would pay the same tax, a maximum of $20,000. On his retirement, he would sell the stock of the corporation or have the corporation sell the land and building and distribute the sales proceeds to him on liquidation and winding up of the corporation. Either way his tax would be a maximum of $20,000, just as if he had not incorporated.

Under the proposals, however, A's corporation would have to pay a corporate capital gains tax of 28 percent, or $28,000. Then -- aside from the new relief provisions discussed below -- when the corporation would be dissolved he would also pay an individual's capital gains tax (on the remaining $72,000) that could amount to 20 percent, or $14,000. His total tax burden on the sale would be $42,000, more than twice the tax he would have paid if he had not incorporated his business. The total tax rate would be 42.4 percent instead of 20 percent.

We submitted that this result was not fair and was not desirable policy.

The Final Report has modified the earlier recommendation by providing some relief at the shareholder level if the value of the stock of the corporation does not exceed $1,000,000, with the relief phasing out gradually until the value exceeds $2,000,000 and eliminated entirely if the value exceeds $2,000,000. The relief takes the form of increasing the tax basis to the shareholder of his stock in the corporation to reduce his personal taxable gain to reflect the corporation's taxable capital gain realized on its disposition of assets held by the corporation for more than five years.

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[1] In certain cases Internal Revenue Code sections 291 and 1250 might cause the effective rate of tax with respect to the building to be somewhat higher than the capital gains tax rates referred to in the illustration, whether or not the business is incorporated.

This relief, even when it would be applicable, would be inadequate, the Chamber submits, for several reasons.

The Increased Tax Rate. The Staff proposals would impose the corporate tax but grant relief from the individual income tax. Under the present law the maximum corporate capital gains tax rate is 28 percent, but the maximum individual capital gains tax rate is 20 percent.[2] Substituting the corporate tax for the present individual tax would mean that in our illustration Individual A would bear a tax of $28,000 instead of the $20,000 he would pay under existing law. The $8,000 additional tax would represent a 40 percent increase in his tax burden.

There appears to be no logical reason why the present tax structure imposes a 28 percent capital gains tax on corporations and only 20 percent on individuals. Indeed, the maximum corporate rate on ordinary income is 46 percent, a figure which is less than the maximum individual rate of 50 percent.

The Staff proposals do not discuss this imbalance between the corporate and individual capital gains tax rates. Yet it is obvious that the effect of the Staff proposals, even where the proposed relief provision is applicable, would be to raise the capital gains tax at the time of sale or liquidation of an incorporated business from 20 percent to 28 percent. We believe this proposed increase would not be warranted nor would it be fair. It would put an increased burden on small incorporated businesses, particularly as compared with small unincorporated businesses, and would unnecessarily discourage the formation of corporations.

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[2] See footnote 1, page 3, *supra*.

Death of the Shareholder. The substitution of a corporate tax for the individual tax would have the marked effect of increasing the tax burden when an incorporated business is sold after the death of the shareholder. In the example used earlier in our illustration, if under existing law Individual A dies, and his executor or heirs sell the business, there will be no capital gains tax to be paid because his stock will take a tax basis for capital gains tax purposes equal to their fair market value at the time of his death. This will be true whether the business is incorporated or unincorporated, because under existing law there would be no corporate tax payable.

Under the Staff proposals there would be no capital gains tax if the business is not incorporated; but if it is incorporated, there would be a 28 percent corporate capital gains tax to be paid. The result would be to substitute a $28,000 tax for a zero capital gains tax under existing law.

In 1976 the Congress passed a highly controversial "carry-over basis at death" rule under which an estate or heir would take over the decedent's basis for assets held at death. That rule would have resulted in an individual capital gains tax being paid on the sale of the business, whether it was incorporated or unincorporated. But because of the complexities and dissatisfaction with the rule, it was repealed in 1980, and at present the executor and heirs have a new basis of fair market value at death. The Staff proposals would leave that situation as it is today if the business is unincorporated; but if the business is incorporated, they would impose a 28 percent corporate tax. The Chamber believes that result would not be warranted and would be undesirable.

The Five-Year Rule. While most corporate assets with significant capital appreciation will have been held for more than five years, the Chamber believes that limiting the relief to assets held for that length of time, as in the Staff proposals, would be unwise and undesirable. Furthermore, it would produce unnecessary complications. When an incorporated business is sold, it would be necessary to allocate the sales price between assets held more than five years and assets held for less than five years, an allocation that would be immaterial to the purchaser. The allocation would be particularly troublesome in the case of buildings and machinery where capital additions to the assets have been made within the past five years. In a going business these changes occur frequently. We see no reason to complicate further the relief provisions by making it unavailable with respect to corporate assets held less than five years. If the business has been conducted for some reasonable period of time, its assets should not be fragmented for this purpose according to the time each asset has been held. If a time period for each asset were to be prescribed for this purpose, we would suggest three years rather than five, particularly as a means of reducing the complications of the calculations.

The $1,000,000 Limit. The proposed relief from double tax would be granted under the proposal only if the net value of the corporation's assets does not exceed $1,000,000.[3] The relief would be phased out between $1,000,000 and $2,000,000 in net value and would be totally denied if the net value exceeded $2,000,000. On the other hand, relief from double taxation provided for Subchapter S corporations is dependent upon the corporation having no more than thirty-five shareholders and is not dependent upon the dollar value of the corporation. Even in section 1244, relating to losses on small business stock, the $1,000,000 limit there used in defining a small business corporation is based upon the amount paid in to the corporation for its capital and not upon the current value of its assets. The Chamber believes it would be unwise to impose a dollar value limit upon the availability of relief from double tax on the sale or liquidation of the business.

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[3] While the $1,000,000 figure may in some circumstances seem large enough, an incorporated business operated over a period of forty years before its sale when an owner retires or dies would represent only $25,000 a year, even without regard to the effects of inflation over such a long period.

Accordingly, the Chamber believes the proposed relief provisions, in their present form, are inadequate and would require revision in important respects. But basically, regardless of the relief provisions, we do not believe the double tax proposal in its present form represents appropriate tax policy.

The "Escape Valve" of "Carry-Over Basis". The Staff proposes that, in general, on the sale of an incorporated business the selling corporation would not realize gain or loss--and hence would not pay a corporate tax on the sale--if the purchasing corporation agrees to take over the tax basis of the selling corporation's assets. Thus if the purchasing corporation elects to use "carry-over basis", the selling corporation would pay no corporate tax on the sale, even though the two corporations are owned by entirely different shareholders.

In the illustration used above, if A's business is incorporated, on the sale by the corporation for $110,000 of its land and its building, which have a cost basis of $10,000, the selling corporation would not have to pay the $28,000 corporate gains tax if it sells the property to another corporation and the buying corporation agrees that for federal income tax purposes it will use the selling corporation's cost basis of $10,000, even though it has actually paid $110,000 in cash for the property. If the purchasing corporation wants to use as its tax basis the amount of $110,000 that it has actually paid for the property, then the selling corporation would have to pay the $28,000 corporate tax in addition to the tax its shareholders would have to pay; but if the purchasing corporation would elect to use the $10,000 carry-over basis, then the selling corporation would not have to pay the $28,000. The two corporations, by agreement between themselves, could produce a deferral of the tax until the buyer resells the property. Even when the purchasing corporation would resell the property when it goes out of business, it could escape the $28,000 tax liability if it could find another corporation to buy the property with an agreement to continue the use of the original $10,000 basis.

We are concerned that the proposal to impose the double tax but permit it to be avoided by finding an incorporated buyer willing to take over the low tax basis could produce anomalous and undesirable results. For example, the selling corporation would be well advised to find a buying corporation that is currently operating at a loss or has a capital loss carry-over or a net operating loss carry-over that it cannot otherwise use.[4] If a buyer corporation has such a loss it would be happy to use the $10,000 carry-over basis even though it paid $110,000 for the property, because the potential capital gain of $100,000 it would realize on the resale of the property would be fully offset by its available loss. Indeed, even if the buyer corporation does not have a loss already realized, it may own property which has depreciated in value by $100,000; it could readily agree to use carry-over basis for the property it was newly purchasing, because it could plan to sell both properties at the same time and offset the loss on the property already owned against the gain on the newly acquired property.

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[4] The limitations proposed in the new rules regarding net operating losses of corporations would not apply if there has been no change in control of the loss corporation.

If such a tax system were to exist, we might expect Individual A in our illustration, when he contemplated the sale of his incorporated business, to seek out an incorporated buyer with such existing or potential losses. Moreover, we could expect the loss corporation to seek out corporations with appreciated property that might be tempted to sell on a carry-over basis deal in order to avoid the double tax. The loss corporation would not even have to operate the properties acquired from Individual A's corporations but immediately after acquiring them could resell them to third parties and use its losses not only to its own advantage but to A's advantage also.

Under these circumstances it could be expected that the financial press would carry advertisements placed by loss corporations seeking to locate other corporations with appreciated property, as well as advertisements placed by the latter type of corporations seeking to find loss corporations willing to buy on a carry-over basis. The spectacle of a seller being able to avoid a tax by locating a buyer with an existing or potential loss is one we suggest the Committee and the Staff should consider with great care before proceeding with the proposals.

The Staff report would not permit the selling corporation to avoid tax if the buying corporation is "exempt from tax". Perhaps one might consider extending this provision to include purchasers which have existing or potential losses. But such a rule would condition the seller's tax upon the extent of the tax losses available to the buyer, involving the seller in tax matters that are confidential as between the buyer and the IRS. We do not believe that result would be desirable.[5/]

Even if the purchasing corporation has no prior or potential losses and eventually must pay a $28,000 tax on its resale of the acquired property, that tax will have been deferred for years simply by agreement of the parties.[6/] A tax paid ten or twenty years later is far less of a burden than a tax payable at the time of the original sale. The recent emphasis on tax issues involving the "time value of money" makes this point clear. One may wonder whether buyer and seller corporations ought to be free to make the choice between paying now and paying later when the sellers have no continuity of interest in the buyer and the transaction involves an all-cash purchase. Elective deferral of tax would be available only between two corporations, not on sales between individuals nor upon sales by individuals to corporations nor upon sales by corporations to individuals. While we are aware of at least some of the reasons that lead the Staff to make this recommendation, we seriously doubt that this special concession to intercorporate all-cash transactions is an appropriate solution.

We are concerned particularly that in addition to abolishing the continuity of interest requirement at the corporate level, the Staff report would also abolish in this setting the judicially imposed "business purpose"

[5/] Indeed, this problem exists to some extent already under the Staff proposal, since the selling corporation's tax could be eliminated only by establishing that the buyer is classed as a corporation (a purchasing trust or partnership may or may not be classified as a corporation for tax purposes), or that it is not "exempt from tax" and is not a "regulated investment company" (which may or may not be the case, depending upon facts relating to the buyer's activities).

[6/] It should also be considered that the acquiring corporation might be subject to lower effective tax rates than the transferor corporation.

requirement stemming from Gregory v. Helvering, 293 U.S. 465 (1935), which at present necessitates "valid non-tax business reasons" for tax-free transfers between transferor and transferee corporations (Report, pp. 16, 50). One may question whether Congress should abolish this judicial safeguard against possible technical manipulation of a highly complex set of new and untried corporate tax rules, and whether judges could be expected to refrain from employing some such rule of reason to avoid perceived inequitable intrusions upon the government revenue. Without a business purpose rule, or some similar safeguard, the optional deferral of tax may be open to maneuvers between corporations which cannot now be adequately predicted and could produce undesirable results beyond those noted above.[7]

General Effect on Incorporated Businesses. Incorporation of businesses is frequently desirable--indeed often essential--as a means of raising capital, insuring centralized management, protecting against death of shareholders or other contingencies. In section 351, and other provisions, the Code has long sought to facilitate incorporations. If the double tax proposal were adopted, those who owned land and buildings needed in the operation of the business would be well advised [redacted] to refrain from transferring those assets to the corporation if the assets might be expected to appreciate in value over time. Instead it would be preferable for the individuals to lease those assets to the corporation, raising factual issues between the taxpayers and the IRS as to the appropriate level of rent to be charged. We do not believe such a pattern would be desirable.

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[7] As an illustration, assume that Corporation T were merged into Corporation P, with T stockholders receiving solely common stock of Corporation P. Under the proposal, no tax would be payable by the T stockholders. If corporation P is not at least 50 percent owned by the T stockholders, Corporation P could choose to step up the basis of the assets acquired from Corporation T, causing Corporation T (but not the T stockholders) to pay capital gains tax on the appreciation. This may prove advantageous to Corporation P if it would pay ordinary income tax on a resale of the assets. One may question the desirability of permitting a step-up in basis of corporate assets on payment of a corporate capital gains tax (especially without a show of business purpose) if there is a substantial (say 49 percent) continuity of interest held by the Corporation T stockholders, and the remaining stock of the acquiring Corporation P is in friendly or scattered hands; yet this could not be accomplished if the T stockholders had a 50 percent or greater interest in Corporation P.

Those persons whose businesses are already incorporated, with appreciated land and buildings presently owned by the corporation, would find themselves trapped in the proposed double tax regime when the business is sold or liquidated. In our statement before the Committee two years ago, we suggested that some of the technical impediments[8/] to the use of Subchapter S by closely held corporations might be waived at the time of sale or liquidation of the incorporated business as a means of providing relief from the double tax. It would appear, however, that the availability of Subchapter S in the Final Report has been tightened rather than liberalized. We respectfully urge that this suggestion be given further consideration. A simpler solution would be to make the proposed double tax treatment inapplicable to capital assets and depreciable property, or at least land and buildings, held by the corporation at the time of winding up the business.

We note that the pending proposals of the President would treat as ordinary income the entire gain on the sale of buildings or other depreciable property used in a trade or business, whereas for many years under existing law capital gain treatment has been accorded to any gain realized over and

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[8/] For example, disqualification from use of Subchapter S by reason of the corporation having more than one class of stock or having a trust as a shareholder (a provision which may be necessary as an administrative matter when there are undistributed gains or losses in the corporation) does not seem necessary when all the assets are being sold and distributed and the recipients are known.

above the original cost of the property (sections 1231, 1245 and 1250; President's proposals, 168-169). If this proposal is adopted, the Staff double tax proposal would cause the total burden to rise even further, because the corporate tax portion would be at ordinary corporate tax rates and not at capital gain rates.

We would also note, however, that the President's proposal to tax as ordinary income the entire gain on the sale or other disposition of depreciable property would only apply to assets placed in service by the taxpayer on or after January 1, 1986. It would not apply to assets heretofore owned. We respectfully suggest that if the Staff double tax proposals were to be enacted, there should be a similar grandfathering of assets placed in service before adoption of the proposal. Such a grandfathering would prevent the entrapment of those existing incorporated businesses that own appreciated property used in their trade or business and acquired with knowledge of the tax structure that has been in existence for many years. At least both old and new businesses would be aware of the drastically changed tax rules when making irrevocable decisions as to their structure for doing business.

While our comments have been primarily directed toward portions of the Staff proposals that we oppose, especially for their adverse effect on small business, we would express once again our admiration for the zeal and the ability with which the Staff has worked so long and hard in this most difficult area.

The proposals would have serious and varying effects upon large business and small business, upon large corporate transacations in the financial centers and upon entrepreneurs in the small towns and farming districts of the country. Despite the fact that the report is very well written, the subject is so complex and the 130-page draft statute so intricate that even those familiar with the field have grave difficulty in comprehending the practical effects that would flow in the event of its adoption. This is particularly true with respect to the effects on small business, which would normally be affected by the proposals only at the time when the business would be sold or liquidated.

Many who might otherwise have studied the report in depth have been preoccupied since its publication last May with the extensive proposals of the President that were forwarded to Congress at the same time. With the exception of the proposals regarding net operating loss carry-overs, which have been under Congressional review for some time, we would urge that the Committee not act upon the Staff recommendations until there is time for further public analysis and debate in a setting removed from the extensive Presidential proposals for tax reform. The Chamber would be pleased to be of assistance to the Committee and the Staff in the further consideration of the Staff proposals.

STATEMENT OF PETER L. FABER, PARTNER, KAYE, SCHOLER, FIERMAN, HAYS, AND HANDLER, NEW YORK, NY

Mr. **FABER**. Mr. Chairman, my name is Peter Faber. I am a partner in the New York law firm of Kaye, Scholer, Fierman, Hays, & Handler. I am a member of just about every tax organization under the Sun; but today I speak as an individual, and not on behalf of any of them.

I would like to focus primarily on the effect of these proposals on small businesses. I should mention that, before moving to New York, I practiced many years in Rochester, NY, where most of my clients were small businesses. In fact, I even represented some family farms. My kids used to complain that when the parents of friends of theirs would come home, they would bring all sorts of interesting things; and the only things I ever brought home were cabbages.

What I would like to do today is to talk a bit about the effect of these proposals on the cabbage farmers of upstate New York.

I think the biggest problem facing the small businessman who wants to sell his business is the complexity and the uncertainty of the law affecting that sale. In fact, even a straightforward cash sale, fully taxable, is uncertain in result because of the collapsible corporation rules.

I testified before this committee 9 years ago urging simplification of the tax law, one of history's great lost causes, and at the time I pointed out that there was a single sentence in the collapsible corporation rules that was about twice as long as the Gettysburg Address. Unfortunately, that sentence is still there and, although I have read it many times since then, I don't understand it any better now than I did then.

Senator **CHAFEE**. One sentence is twice as long as the Gettysburg Address?

Mr. **FABER**. That is correct, sir, 341(e)(1) of the Code.

The law, in addition to being complicated, is illogical. Present law allows a sale by a corporation of its inventory to go wholly untaxed, and that makes no sense to me.

Now, if the small businessman wants to sell out in a tax-free reorganization, he has to face not only a complex statute but also a set of rules that isn't even in the statute. I would submit that the principal burden of today's illogical and complex scheme falls on the small businessman and not the large businessman. The owner of a small business cannot afford to hire the people on this panel to tell him how to sell his business; he uses a small firm or a single practitioner in Painted Post, NY, or Horseheads, and these folks can't even find the rules much less understand what they say.

The proposed statute would eliminate much of the complexity: it would repeal the collapsible corporation rules. In a tax-free deal each shareholder would be taxed based on what that person received—if you get stock, you are not taxed; if you get cash, you are taxed. The continuity of interest and business enterprise rules would be done away with, as they should be.

I would submit that a double tax on recognized gains is a small price to pay for the greater simplification and the ease of understanding the rules that would result.

I would also submit that many of the horrible results that have been hypothesized by opponents of these proposals would not occur.

It has been suggested that people would be reluctant to incorporate businesses that logically should be incorporated because of the increase in tax on any gain that would result way down the line when they sold out. I have advised an awful lot of people forming small businesses, and my experience has been that normally the decision to incorporate is based on things like the need for limited liability and more immediate tax consequences, and that people rarely think of what is going to happen 20 years down the road when they sell out.

Under the staff proposal there still would be a bias in favor of incorporation, because you could sell out tax-free; whereas, you could not, in most cases, if you did not incorporate.

But looking ahead to that ultimate sale, most people who form a business are going to be in it for 15, 20, 25 years. They don't know what the law is going to be when they sell out. They don't know what the rates are going to be. The one thing they know is that people in Washington will have changed the rules by then, and the last thing they think about is that tax on sale. There are much more important factors that influence the decision to incorporate.

The act would not increase the circumstances in which people keep property out of a corporation and lease it to the corporation, which it has been suggested is a complexity. There are plenty of reasons under present law for doing just that right now, and my written statement details some of the reasons why most family farmers would prefer to keep their land out of the corporation and not put it in under present law.

I suspect that very few people formed existing corporations in reliance on their ability to some day sell out at a tax rate of 20 percent. Indeed, many thought that the capital gains rate would be 35 percent. I don't think we would see too many people who were ambushed.

In short, Mr. Chairman, I think that the proposals would benefit small business by simplifying the lives of small businessmen and their advisors. I think the family farm has much more to fear from high interest rates than it does from these proposals.

Senator **Chafee**. All right. Thank you very much.

Mr. Roche.

[Mr. Faber's written testimony follows:]

STATEMENT OF PETER L. FABER
COMMITTEE ON FINANCE
UNITED STATES SENATE
SEPTEMBER 30, 1985

THE SUBCHAPTER C REVISION ACT OF 1985
EFFECT ON SMALL BUSINESS

My name is Peter L. Faber. I am a partner in the New York City law firm of Kaye, Scholer, Fierman, Hays & Handler, and I have been pleased to serve for the last few years as a member of the Subchapter C Working Group that has assisted the Staff of the Committee on Finance in preparing the proposed legislation that is before you today. Although I am the Secretary of the American Bar Association Section of Taxation, a past Chairman and member of the Executive Committee of the New York State Bar Association Tax Section, and a member of the Tax Committee of the Association of the Bar of the City of New York, I appear before you today as an individual and not on behalf of any organization or client.

I would like to concentrate my remarks today on the effect of the proposals on small business. At the hearings on October 24, 1983, following the release of the Staff's preliminary report, some groups testified that the proposals would have an unduly harsh impact on small businesses and might discourage the formation of corporations in the future and trap those who had unwittingly incorporated small businesses in the past. I believe that these criticisms are unfounded. Much of my practice for the last 22 years has consisted of advising small and medium-size businesses, and I strongly believe that the Staff proposals would not have the draconian effects on small corporations that some of their opponents have hypothesized.

The proposals would vastly simplify the law governing the taxation of sales of corporate businesses. Although the proposed Subchapter C Revision Act of 1985 (the "Act") may appear at first reading to be complex, with new terms and concepts, I am convinced that practitioners would become familiar with it in time and would find it significantly easier to understand then today's elaborate and inconsistent statutory scheme. While it may be a truism that familiar complexity is better than unfamiliar complexity, I believe that the Act would in time become that best of all possible worlds, familiar simplicity.

Problems in Selling Corporate Businesses Under Present Laws.

A person desiring to sell a small incorporated business under present law must make his way through a treacherous minefield planted by the Internal Revenue Code.

Even if the transaction is to be a simple cash sale in which gain will be recognized in full, the tax consequences are often uncertain. Although in theory the business can be sold at the cost of a single shareholder-level capital gains tax, regardless of whether the transaction takes the form of a sale of stock by the shareholders or a sale of assets by the corporation followed by its liquidation, this result may be hard to achieve and, more importantly perhaps, the selling shareholders may never be sure that they will achieve it.

The principal obstacle is §341 of the Code, which imposes ordinary income treatment on the sellers of stock of "collapsible corporations." These provisions were designed to ensure that people who formed a corporation in order to acquire property and who sold the corporation's stock before a substantial part of the taxable income from the property had been realized would have their gain on the sales taxed as ordinary income and not capital gain. Although the collapsible corporation provisions were designed to apply to particular abusive situations in the motion picture and real estate industries, they were broadly drafted and there are very few small business corporations that are not at least arguably collapsible. It is ironic that the statutory scheme developed to implement these concepts and that applies primarily to small corporations is among the most complex in the Code. It includes a single sentence that contains almost twice as many words as the Gettysburg Address (and considerably less wisdom). Although there are exceptions to the collapsible corporation rules, qualification for them is often uncertain.

If the selling shareholders wish their transaction to be tax-free, the complexity and uncertainty to which they will be exposed is truly frightening. In order for the sale of a corporate business to be tax-free, it most qualify as a "reorganization" under §368 of the Internal Revenue Code. Qualification requires compliance with a series of tests, some of which appear in the statute, some of which appear in the regulations, some of which appear in the case law, and some of which arguably appear only in the imagination of the Internal Revenue Service.

Section 368 has developed in fragments over the years and now contains a bewildering variety of rules that apply technical and different tests to many transactions that might appear at first blush to be economically identical. For example, if a target corporation transfers its assets to a buying corporation in exchange for the buyer's stock and liquidates, the transaction will be tax-free to the target shareholders only if (in most cases) all of the consideration is voting stock of the buyer and if substantially all of the target's assets are transferred. §368(a)(1)(C). If, instead, the target merges into the buyer in a statutory merger under state law, a transaction that in most cases is economically identical to the "C" reorganization, a substantial amount of the consideration can be cash, the buyer's stock used in the transaction need not be voting stock, and there is no requirement that substantially all of the target's assets be transferred.

Illogic aside, the technical requirements of §368 are hard to comply with and often trap the advisers of small businesses, who may not be sophisticated tax specialists. Let me offer two examples, both dealing with the requirement that in many transactions the consideration must be solely voting stock of the acquiring corporation.

Assume that the target corporation has two shareholders, one of whom is actively employed by the business and one of whom is an investor. The employee owns 55% of the target's stock and the investor owns 45%. The acquiring company proposes to employ the active shareholder after the acquisition and gives him an employment contract providing for a salary, bonuses, and fringe benefits. Each target shareholder receives two shares of the acquiring corporation's stock for each share of the target stock that he owned. Although this transaction seems relatively straightforward, the Internal Revenue Service may disqualify it if it finds that the active shareholder's employment agreement was too rich in relation to the services expected to be performed. If the Service argued that part of the value of the employment agreement was attributable to a control premium paid on the active shareholder's stock, the "solely for voting stock" requirement would be violated and the transaction would be fully taxable as to both target shareholders.

Assume that in the above example there was no employment agreement but that the acquiring corporation included in its boiler-plate representations and warranties a representation that its financial statements that had been submitted to the target shareholders before the transaction were accurate. The target shareholders would obviously be concerned about the accuracy of the buyer's financial statements since any inaccuracy might adversely affect the value of the buyer's stock that they received. Since most agreements ordinarily provide that a material breach of a representation will result in cash payments to the selling shareholders equal to their resulting loss, the inclusion of such a provision could violate the "solely for voting stock" requirement. This will not be a problem if the attorneys for the parties are clever enough to provide that the remedy for a breach of this particular representation will be the payment of additional shares of voting stock to the target shareholders and not cash, but this is a sufficiently esoteric point that the advisors to many small businesses (and, for that matter, many large ones) may not pick it up.

The traps are not always included in the statute. The courts and the Internal Revenue Service have for many years provided that a transaction could not qualify as a tax-free reorganization unless the "continuity of interest" and "continuity of business enterprise" tests were satisfied. The continuity of interest test requires that the shareholders of the target corporation retain a significant interest in the transferred business in the form of ownership of the buyer's stock that represents a substantial part of the consideration received. The continuity of business enterprise requirement, recently incorporated in detailed regulations for the first time, requires, in the Service's view, that the buyer continue to operate the target's historic business or continue to use in a business a significant portion of the target's historic business assets. The continuity requirements were intended to insure that the tax-free reorganization provisions would not apply to transactions that were in substance cash sales. The courts found it necessary to impose the continuity of interest requirement because the initial reorganization statute, as does the present one, flatly provided that any statutory merger would be tax-free. The courts felt, quite properly, that this should not apply to a transaction that was in form a statutory merger under state law even though the only consideration received by the selling shareholders was cash or promissory notes.

Unfortunately, the continuity rules, although first announced some fifty years ago, are still uncertain in application. The principal problem areas in the application of the continuity of interest rule to small businesses have to do with the amount of consideration that must be stock of the acquiring corporation and the extent to which the selling shareholders must hold this stock after the transaction. As to the amount, the Internal Revenue Service will give a favorable ruling if at least 50% of the consideration by value is stock. Some courts have been more generous, but the extent of the confusion is illustrated by the fact that a Supreme Court case, which is often cited for the proposition that as little as 38% of the consideration can be stock, in fact involved some additional contingent stock so that the stock received by the target shareholders comprised slightly over 41% of the consideration. John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935). Although transactions have often proceeded on opinion of counsel where stock comprised as little as 40% of the consideration, the uncertainty in this area is indefensible and frightening to a sole practitioner advising the owners of a small corporation on a prospective sale of their business.

Even more of a problem relates to the extent to which the target shareholders must continue to hold their stock after the transaction. In my experience, owners of a small business who are selling out in a tax-free reorganization want to be free to sell their stock of the buyer as soon as possible so that it, or at least a substantial part of it, can be converted into cash. I have often been asked by target shareholders how soon they can sell their stock, and, unfortunately, I have not been able to give them a clear answer. The Internal Revenue Service apparently takes the position that a sale by a target shareholder that had been pre-arranged before the transaction will result in the sold stock being treated as cash in applying the continuity of interest test. Although many commentators have expressed the view that a sale to a third party should have no effect on the transaction even if contemplated beforehand, the Internal Revenue Service seems to disagree and at least one court has held that a sale to third parties that was pre-arranged in part with the assistance of the acquiring corporation has to be counted on the wrong side of the continuity of interest equation. MacDonald's Restaurant, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

The post-transaction retention requirement can place minority target shareholders in an impossible position. Assume, for example, that the target corporation has two shareholders, one of whom owns ten percent of its stock and the other of whom owns ninety percent. The shareholders negotiate a transaction with an acquiring corporation that they believe will be a tax-free reorganization. Unknown to the ten percent shareholder, the ninety percent shareholder has arranged in advance to sell his buyer stock to an unrelated third party for cash immediately after receiving it. In the Service's view, this apparently will defeat continuity of interest and the purported reorganization will be fully taxable not only to the majority shareholder, who deserves it, but to the minority shareholder who plans to hold his buyer stock forever and who deserves a better fate.

The post-transaction problem also arises in the context of the continuity of business enterprise requirement. If the acquiring corporation plans to dispose of the business after the transaction, continuity of business enterprise will apparently not be present in the Service's view and the transaction will be fully taxable to the target shareholders, even if they knew nothing of the acquiring corporation's plans. I have been in the position of representing shareholders of a family business who suspected that the acquiring corporation might well be interested in selling most of the target's business after the transaction. We were able to get limited representations from the buyer that it would not do this, but the buyer was unwilling to give us representations that fully satisfied us and the transaction proceeded in an atmosphere of considerable uncertainty.

In summary, the present statutory scheme is illogical and uncertain. Its principal victims are the owners of small businesses who cannot afford to pay sophisticated tax counsel to guide them through the maze.

The Act Would Eliminate Most of the Traps in the Present Statutory Scheme that Affect Sales of Small Businesses.

By eliminating the last vestiges of the so-called *General Utilities* principle, that permits corporations to distribute appreciated property in complete liquidation without paying tax on the gain (or to sell them in a transaction that occurs in connection with a complete liquidation without paying tax), the Act would eliminate the need for the collapsible corporation provisions and those provisions would be repealed. The collapsible corporation rules have been a principal source of uncertainty in taxable sales of family businesses, and their repeal would vastly simplify planning in this area. Although the capital gains taxes might be higher than under present law, at least capital gains treatment could be assured. Those taxpayers who have stubbed their toes on the collapsible corporation provisions can testify that this assurance is worth paying for.

The biggest simplification for sellers of small businesses would be in the tax-free transaction area.

Under the Act, it would no longer be necessary to qualify a transaction as a "reorganization" for the target shareholders to have tax-free treatment. A target shareholder receiving stock of the acquiring corporation would be entitled to tax-free treatment with a carryover basis regardless of the consideration received by the other target shareholders and regardless of the characterization of the transaction at the corporate level (i.e., whether cost or carryover basis). In the example posed above, the ten percent target shareholder could be assured of tax-free treatment regardless of whether the ninety percent shareholder promptly sold his buyer stock for cash pursuant to a pre-arranged transaction. In fact, the minority shareholder could be assured of tax-free treatment if he received buyer stock even if the ninety percent shareholder received cash directly from the acquiring corporation as consideration in the transaction. This result is eminently fair. The minority shareholder continues to hold the same interest in the transferred business through his ownership of the buyer's stock regardless of what happens to the other target shareholders, and the taxation of the transaction as to him should not be affected by what happens to them.

Both continuity rules would be repealed. Unsuspecting target shareholders could no longer be trapped by a pre-arranged sale of their corporation's business by the buyer immediately after the transaction. As long as they receive buyer stock, their tax-free treatment would not be affected by the buyer's subsequent conduct.

Transactions would be taxed under the Act in accordance with their economic substance and economically identical transactions would not be subject to different rules. I suspect that the single practitioners and small firms who advise the great majority of the country's small businesses would quickly become comfortable with the new rules and would find them considerably easier to work with than the present ones.

The New Rules Would Not Unfairly Affect Small Businesses.

The Act would impose the same double tax on sales of corporate businesses that the law now imposes on current earnings of a corporation that are distributed to shareholders. Although this would undoubtedly increase the tax burden on the sale of any incorporated business, large or small, it represents sound tax policy in the context of a two-tier system that treats corporations and shareholders separately. I will not repeat all the arguments in favor of complete repeal of the General Utilities principle. They are set forth in a report of an American Bar Association Section of Taxation Task Force that I chaired and that was published at 37 The Tax Lawyer 625 (1984), along with a minority report presenting the contrary position. In general, the principal arguments in support of repealing the General Utilities principle are that (1) liquidating distributions and sales should not be treated differently from current distributions and sales, (2) the present scheme permits appreciation in the value of FIFO inventory to escape tax altogether despite the fact that it represents assets that the corporation is in the business of selling and that will be sold by the buyer in the ordinary course of its business, and (3) repeal would enable elimination of the collapsible corporation provisions.

Although it would theoretically be possible to enact the gain recognition and basis provisions of the Act without repealing the General Utilities principle, the Treasury Department has made it clear that it would oppose such an arrangement, and a failure to repeal General Utilities might give rise to manipulation that could result in a disruption of the proposed statutory scheme. I will therefore assume that the repeal of General Utilities, which has been singled out by opponents of the Act as the principal provision that would adversely affect small business, will be an integral part of any corporate tax reform legislation to be considered by this Committee.

There is no question but that the proposed repeal of General Utilities would increase the cost of selling any corporate business in a taxable transaction. The increased cost would make tax-free transactions more attractive vehicles for selling small businesses relative to the alternatives than they were in the past. This could in turn lead to an increased tendency for owners of small businesses to sell their businesses to publicly held corporations since ordinarily, as a practical matter, tax-free reorganizations in which the buyer is itself a closely held corporation are uncommon. I suspect that this would not significantly affect the landscape of American business, but I leave that to the economists.

Some of the other possible consequences of this increase that were suggested by opponents of the Staff proposals at the 1983 hearings are, I submit, red herrings.

It has been suggested, for example, that the increased tax would result in owners of small businesses being reluctant to incorporate. I doubt very much that this would be the case. I have been involved in the incorporation of many small businesses and I can honestly say that I have never had a client ask me at the time that the decision to incorporate was being made about the tax consequences upon the sale of the business. The decision to incorporate has been principally motivated by the desire for limited liability and the availability of corporate fringe benefits when they were substantially more attractive than those available to partnerships and sole proprietorships. Most people who start new businesses, particularly family businesses, expect to operate them indefinitely and the tax consequences of an ultimate sale are far from their minds. If they expect to sell out in the foreseeable future, they generally assume that the corporate form of doing business offers them the option of a tax-free sale, which the partnership form ordinarily does not. To the extent that they think about the possibility of a taxable sale, my clients have generally assumed that the tax impact will depend on the rates and substantive law that are in existence at the time and that cannot be predicted with any degree of accuracy. It is thus inconceivable to me that a significant number of businesses will choose not to incorporate because of any provision that the Act might contain.

Some opponents of the Staff's proposal suggested at the 1983 hearings that they might create an incentive for owners of small businesses to keep land, buildings, and other major assets out of the corporation and to rent them to the corporation. This was suggested as being an undesirable complexity. My experience has been that most well-advised owners of small businesses use this technique under present law, and the enactment of the Act would not change their practice. Farmers, for example, ordinarily do not incorporate their land because to do so would prevent them from selling part of it and distributing the proceeds without a double tax, part of which would be ordinary income at the shareholder level, under present law. Owners of small businesses often keep depreciable assets out of the corporation so that they can get the benefit of the depreciation on their individual income tax returns. The lease arrangement offers a way of getting income out of the corporation without being exposed to the double tax on current earnings that are distributed as dividends, since the corporation can deduct the rental payments.

It has been suggested that many people have formed corporations in the expectation that the business could eventually be sold at the cost of only a single-level capital gains tax and that these expectations would be frustrated unfairly by repeal of the General Utilities principle. As indicated above, I suspect that very few people have been significantly influenced by the availability of a single-level capital gains tax in deciding to form corporations. Moreover, to the extent that they were, those decisions would undoubtedly be affected by prevailing tax rates. It is likely that many corporations in existence today were formed when long-term capital gains were taxed to individuals at rates of up to thirty-five percent, increased by whatever form of alternative minimum tax may have been in effect at the time. For these people, a combined corporate and shareholder tax of 42.4% would not be significantly higher than the tax they may have expected to pay. Moreover, the Act would expand present §333 to permit tax-free liquidations in kind so that people who had regretted an earlier decision to incorporate would be able to reverse that decision without immediate pain.

The Act would provide a limited exemption from the double tax with respect to certain small corporations by providing a shareholder-level credit (through the mechanism of a basis adjustment) for corporate-level tax paid with respect to capital assets that had been held by the corporation for more than five years. The credit would be limited to corporations with a fair market value of two million dollars or less and would be scaled down with respect to corporations with a value of between one million dollars and two million dollars. There is no theoretical justification for the credit other than a desire to reduce the impact of the double tax on small businesses. If there is to be an exception for small businesses, I would favor setting the cut-off point at a higher level (e.g. five million dollars or ten million dollars). It does not take much in the way of assets to get to a two million dollar value, particularly in this era of inflated real estate prices.

Conclusion

The provisions of the Act relating to sales of corporate businesses would simplify substantially the planning of sales of small businesses. By eliminating the collapsible corporation rules and the many technical requirements that must be met to qualify a transaction for tax-free treatment, the Act would make it possible for small businesses and their advisors, who very often are not sophisticated tax practitioners, to plan for the sale of a business with certainty as to the tax result.

Although the repeal of the *General Utilities* principle as applied to liquidations and liquidating sales would increase the tax cost of selling an incorporated business in a taxable transaction, this increase would not result in a reluctance to incorporate small businesses nor would it change existing business practices. The Act would not unfairly undermine existing business structures that had been predicated on the ability to sell at some point in the future at a single-level capital gain tax. The added cost that would be imposed with respect to taxable sales of businesses would be a small price to pay for the simplicity and rationality of the proposed statutory scheme.

STATEMENT OF JAMES M. ROCHE, PARTNER, McDERMOTT, WILL & EMERY, CHICAGO, IL

Mr. ROCHE. My name is James Roche. I am a partner in the law firm of McDermott, Will & Emory in Chicago. I am here to speak as a practitioner and offer some observations based on practical experience.

I would say at the outset that I would agree with the objectives of the staff's proposals and study, and generally would also agree with the approach. However, I would also agree with the notion that has been expressed here earlier today, that it might be best to defer the consideration of these proposals, with the exception of the net operating loss carryover provisions, until general tax reform has been finally resolved. I think there may be some things that would come out of a general tax reform that would influence the way in which we might view these proposals.

I am going to limit my comments primarily to what the other panelists on this particular panel have discussed, and that is the effect of the repeal of general utilities in connection with the asset sale of a business or the liquidation in kind of a business, particularly the repeal of sections 336, 337, 338, and the modifications of section 333. Again, I want to focus on closely held corporations or family businesses.

I would point out, as I guess has already been pointed out, that these proposals could have the effect now of doubling the tax that is payable in connection with the sale of these businesses. And I question whether such a startling tax result is appropriate when what we are discussing here is more in the nature of structural reform or simplification.

I also do think that there is some aspect of changing the rules of the game after it has started. Mr. Faber has indicated that not too many of his clients focus on what happens at the end of the road. And while I agree that it is not uppermost in the mind of a businessman who is starting a new venture, it is certainly something that is explained, and it does become a factor in choosing the form of organization.

I also think that these proposals would create a bias toward sales of businesses to larger corporations. Larger corporations are perhaps better able to absorb carryover-basis acquisitions. They have available to use as consideration stock which creates liquidity for the selling shareholders and also permits them to defer the tax.

The staff does, of course, provide some limited degree of relief; however, it is focused at the shareholder level. Our proposals, which are detailed in our written testimony, would focus that relief at the corporate level, but we would retain the limitations generally that the staff has proposed to historic capital assets.

The staff also would limit the relief to corporations that have a fair value of a million dollars, and it would scale down up to the point of $2 million. We disagree with that approach. We think it could create some impetus to sell a growing business. If a business reaches the stage where it is worth a million dollars, I think the owners would have to look at it and decide whether it was worthwhile to continue growing that business or to sell and get out while they could get the benefit of some tax relief.

Our proposal is not to focus on the dollar size of the business but to take the approach that appears elsewhere in the code, particularly in connection with subchapter S. We think it is better to focus on the number of shareholders. We would suggest 35 shareholders or less. It would be an appropriate level to provide relief. We would also note that this same approach has been taken in connection with section 311.

Another aspect of the proposals that we are troubled by has to do with the shareholder flavoring suggestion that would attribute to the corporation the activities of the shareholders. This, in effect, could result in converting what would be capital gain at the corporate level to ordinary income. We think that is wrong. We think that the principle of respecting the difference between the corporation and its shareholders is long established, and it is a wise one. We would also point out that a significant price is paid for that in the form of a double-tier system of taxation. We think that these distinctions should be retained.

Finally, I would say a word about the transition rules. We think it is important that a period of at least 12 months be provided, and we would also suggest that during that 12-month period there be an ability to make an election to be governed by the old rules or the new rules.

Thank you.

Senator CHAFEE. Thank you very much, Mr. Roche.

Mr. Thompson.

[Mr. Roche's written testimony follows:]

WRITTEN STATEMENT OF JAMES M. ROCHE AND LAWRENCE H. JACOBSON OF MCDERMOTT, WILL & EMERY BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE WITH RESPECT TO THE SUBCHAPTER C REVISION ACT OF 1985

The Subchapter C Revision Act of 1985 ("the Act"), as drafted by the Senate Finance Committee Staff represents a laudable attempt to change the federal income tax treatment of corporate formations, acquisitions, and liquidations. While we do not agree with all of the Staff's recommendations, we want to commend the Staff for putting forth a carefully thought out proposal to reform the taxation of corporations and their shareholders.

At the outset, we want to stress our opposition to making the Act a part of the President's tax reform package. We believe that the proposals set forth in the Act involve different tax policy considerations than the President's tax reform package. The President's tax reform package to a large extent deals with the redefinition of the concept of taxable income while the Act deals with the redefinition of rules governing corporate distributions and adjustments. Given the nature of these different proposals, we believe that separate consideration should be given to each.

Our written testimony will primarily discuss our concerns regarding the Staff's proposal to repeal the doctrine enunciated in General Utilities & Operating Co. v Helvering, 296 U.S. 200 (1935) in the context of complete liquidations. While we will address other issues raised by the Act, the proposed repeal of General Utilities is of such importance that we feel it necessary to set forth our concerns in detail. Our comments will be limited to the application of General Utilities in complete liquidations and we express no view as to the application of the doctrine in the context of ordinary or redemption distributions governed by section 311 of the Code.

A. Analysis of Present Rules Governing Liquidations

The doctrine enunciated in General Utilities, as set presently forth in sections 311 and 336, allows a corporation to distribute, as a dividend or in complete liquidation, appreciated property without the imposition of a tax at the corporate level, with the exception of recapture items and LIFO inventory. Section 337 further provides that a corporation which sells assets within a 12 month period commencing on the date a plan of liquidation is adopted shall not recognize any gain or loss (except for recapture items and LIFO inventory) upon such sales. Section 337 compliments section 336 in that any Court Holding Company issue as to whether the liquidating corporation or its shareholders "sell" corporate assets is irrelevant.

Section 333 is applicable to a complete liquidation where, under certain circumstances, a shareholder is entitled to defer recognition of gain upon receipt of appreciated property as a liquidating distribution. Assuming proper elections are made and the liquidation occurs in a single calendar month, an individual shareholder recognizes gain to the extent of (1) such shareholder's pro rata share of the earnings and profits of the liquidating corporation, and (2) the excess of the amount of any money and value of any stock and securities received over the shareholder's ratable share of earnings and profits. An individual shareholder will recognize ordinary income to the extent of his pro rata share of the corporation's earnings and profits and any gain recognized in excess of such amount is taxed as a capital gain. The shareholder's adjusted basis in assets received equals the shareholder's adjusted basis in his stock in the liquidating corporation decreased by the amount of money received by the shareholder and increased by the amount of gain recognized by such shareholder.

Notwithstanding some perceived abuses identified by the Staff, sections 333, 336 and 337 have operated in an manner in which bona fide corporate liquidations can be effected at a reasonable tax cost. Our experience indicates that few liquidations are tax motivated and most liquidations are driven by business concerns of corporations and/or their shareholders. Although the Staff talks about the Code providing a "bias in favor of liquidating transactions", we have not seen any practical tax bias of structuring corporate acquisitions as liquidations. Nontax concerns such as assumption of contingent liabilities and the necessity to sell corporate assets to more than one purchaser are forces which drive transactions to be structured as asset acquisitions of liquidating corporations. These factors, and not tax concerns, normally result in structuring acquisitions as liquidations.

Two primary concerns of the Staff which appear to be behind the effort to repeal General Utilities involve collapsible corporations and liquidation-reincorporation abuses. We believe the repeal of the collapsible corporation rules, which are admittedly complex, should not be used as a principal justification for repealing liquidation provisions which have generally worked to prevent the imposition of unreasonable high taxation upon shareholders of liquidating corporations. As an anti-abuse section of the Code, section 341 must be comprehensive enough to attack as many abusive situations as possible. Yet the necessity of section 341 merely illustrates the fact that Subchapter C cannot always work in a "simple" manner. We would rather see the retention of one complex Code provision in Subchapter C, rather than the complete elimination of liquidation provisions which have generally worked without abusive consequences. However, the historic asset limitation discussed below should go a long way to eliminating the collapsible corporation problem.

In the area of liquidation-reincorporation transactions, the Commissioner was recently given two significant weapons in recharacterizing "liquidations" as bailouts of earnings and profits. Section 346(b) gives the Secretary the authority to promulgate broad regulations to ensure that transactions which, in substance, are partial liquidations may not be governed by sections 351, 355, 337 or any other provision of law or regulations (including the consolidated return regulations). Moreover, section 368(c)(2) was recently amended to reduce the "control" requirement for purposes of a nondivisive "D" reorganization to mean either (1) 50 percent of the total combined voting power of all classes of voting stock or (2) at least 50 percent of the total value of shares of all classes of stock. These two statutory provisions give the Commissioner the necessary authority to attack liquidation-reincorporation transactions.

Moreover, the Act provides a further safeguard against liquidation-reincorporation in section 365(d) which states that a cost basis election cannot be made when one or more persons in control of the acquiring corporation immediately after the acquisition date were in "control" of the target corporation. For this purpose control is defined in the exact same manner as current section 368(c)(2). Given these tools to deal with the problem, it is difficult to justify the elimination of provisions as important as sections 333, 336 and

337 on the grounds of providing marginally greater protection.

We remain convinced that the theory underlying sections 336 and 337, i.e., the imposition of a single level of tax (except for recapture and tax benefit items) upon the cessation of business activities in corporate form, continues to be valid. The imposition of a corporate and shareholder level tax in the context of complete liquidations will result in the excessive taxation of corporate readjustments.

B. Analysis of Act as it Applies to Sections 336, 337 and 338

As we stated in our testimony two years ago, the economic impact of the Act is to impose a heavier tax burden upon subchapter C corporations and their shareholders than upon partners in a partnership. This is because the distribution of an appreciated asset by a partnership to a partner does not generally result in the recognition of income to the recipient partner or the distributing partnership.

We continue to maintain that if the Act is enacted into law, tax considerations will unnecessarily determine whether certain business operations will be conducted through a corporation or partnership. However, as a practical matter, most large scale businesses cannot be operated as partnerships. Moreover, while Subchapter S may be a viable alternative for some corporations, S status is not possible in many circumstances. A corporation which has preferred stock outstanding or owns a subsidiary is ineligible to make an S election. In addition, stock in family corporations is often held in trusts for valid estate planning reasons. Thus, the net result of the staff proposal is to introduce a new tax upon business entities which cannot be operated as partnerships or S corporations.

The economic burden of eliminating General Utilities doctrine will fall squarely upon the owners of closely held corporations. Entrepreneurs who devote their energy and capital to building up the value of closely held corporations will suffer severe economic consequences as a result of the elimination of Code sections 336, 337 and 338. For example, if the acquiring corporation fails to make a cost basis election with respect to the acquisition of target corporation's assets, the purchase price paid by acquiring corporation, all things being equal, will be reduced by the present value of the net tax savings which would have inured (directly or indirectly) to the benefit of the acquiring corporation. On the other hand, if the acquiring corporation makes a cost basis election, the net proceeds available to the shareholders will be reduced by the corporate level tax on the sale of the assets. In either case, the net amount received by shareholders of closely held corporations with respect to the sale of business enterprises will be significantly reduced. We do not view it as appropriate at this time to increase the tax burden upon persons who are shareholders of closely held corporations.

The repeal of sections 336, 337 and 338 would provide a significant disincentive towards investment in stock of closely held corporations. An individual would be able to invest in publicly traded equities, real estate or precious metals, and pay a capital gains tax of no more than 20 percent. In addition, the purchaser would obtain a cost basis in such assets. On the other hand, absent any relief, an entrepreneur can be taxed at a rate (assuming a 28 percent effective corporate rate on capital gains and a 20 percent shareholder level capital gain rate) of 42.4 percent upon the complete liquidation of his corporation. Since the Act would, in some instances, more than double the tax burden relating to corporate liquidations, we believe it is inappropriate to state that the repeal of General Utilities is truly "tax reform" or merely structural.

We strongly support the retention of some form of section 336, 337 and 338 protection with respect to actual or deemed complete liquidations of closely held corporations. The Staff proposal sets forth limited relief in the form of a basis adjustment of a shareholder's stock in a "small business corporations" in the case of an acquisition or liquidation of that corporation. The basis of an "eligible shareholder's" stock in the liquidating corporation would generally be increased by such shareholder's pro-rata (by value of stock owned) share of the "aggregate basis adjustment." For this purpose the term "aggregate basis adjustment" would equal the amount of the "long-held capital gain tax" (on corporate capital assets which have a holding period of five years or more at the time of disposition) divided by 0.28 less the "long-held capital gain tax." These special basis adjustment rules apply fully to any corporation whose fair market value on the liquidation is $1 million or less. It is reduced proportionately to zero for businesses with a value of between $1 million and $2 million.

We do not support the use of a basis adjustment mechanism as a means of alleviating problems associated with the repeal of General Utilities. First, even if the full amount of a basis adjustment is made available to a shareholder, the net effect of the Staff Proposal is to increase the tax burden from no more than 20 percent to 28 percent upon the shareholders who sell their closely held corporations. Second, the Staff's definition of an eligible corporation based upon the size of a corporation rather than the number of shareholders is totally contrary to the relief provisions presently available to shareholders of closely held corporations. Present law provides that a corporation can have up to 35 shareholders and remain eligible for "S" corporation treatment. Moreover, the present relief provisions of section 311 apply to holders of "qualified stock", i.e., persons who directly or indirectly held at least 10 percent in value of the outstanding stock of the distributing corporation during the lesser of the five year period ending on the date of distribution, or the period during which the distributing corporation was in existence. Neither the "S" corporation nor qualified stock provisions of the Code are based upon the fair market value of the assets of the corporation. We strongly oppose any effort to tailor any General Utilities relief measures to the value of a corporation's assets.

1. Recommendation as to Appropriate Relief Measures in Section 336, 337 and 338 Contexts.

We are proposing that current 336, 337 and 338 protection be retained at the corporate level upon the distribution, actual sale or deemed sale of "historic capital assets" by "eligible corporations" to the extent of the percentage of shares held by "qualifying shareholders." "Historic capital assets" would be defined as capital assets (or property the gain or loss of which is section 1231 gain or loss) held by the corporation during the lesser of the five year period ending on the date of transfer, or the period during which the corporation was in existence. An "eligible corporation" would be defined as a domestic corporation which has 35 or fewer shareholders. A "qualifying shareholder" would be any shareholder who held his stock for the one year period immediately prior to the qualified stock or asset acquisition except shareholders that are exempt from taxation on capital gain income (such as pension funds, section 501(c)(3) organizations or foreign persons who are not subject to United States taxation upon the receipt of capital gains) would not be "qualifying shareholders."

Under our proposal, an eligible corporation would recognize full gain or loss upon the sale of ordinary income assets (such as inventory) or any capital asset which is not a historic capital asset. In addition, the eligible corporation would recognize gain or loss with respect to historic capital assets to the extent of the percentage of shares held (determined by reference to the fair market value of all shares of stock outstanding except for shares which are limited and preferred to dividends) on the acquisition date by persons other than qualifying shareholders. This concept is similar to the gain recognition provisions of section 338(c). Our proposal is carefully tailored to limit the application of the General Utilities doctrine to long held capital assets held by closely held corporations and only to the extent that capital gain or loss is utimately recognized at the shareholder level i.e., to avoid a double tax - not all taxes. The following example will indicate the application of our proposal.

ABC Corp. is a closely held wholesale grocery operation located in the Midwest. ABC Corp. has a single class of common stock outstanding which is held by 20 shareholders.

Fifteen percent of the shares are held by persons who are exempt from capital gains taxation. The adjusted basis of ABC Corp.'s ordinary income assets (including recapture items) is $3,000,000 and the fair market value of such assets is $4,000,000. The adjusted basis of ABC Corp.'s nonhistoric long term capital assets is $1,000,000 and the fair market value of such assets if $2,000,000. The adjusted basis of ABC Corp.'s historic capital assets is $1,000,000 and the fair market value of such assets is $4,000,000. Acquiring Corp. wants to make a qualified asset acquisition and is willing to pay $10,000,000 for ABC Corp.'s assets. Acquiring Corp. wants to make a cost basis election with respect to the acquisition of ABC Corp.'s assets. For purposes of this example, we are assuming that ABC Corp. will be subject to a 46 percent tax rate on ordinary income and a 28 percent rate on recognized capital gains.

Under our proposal, ABC Corp. is an eligible corporation. It would recognize income of $1,000,000 with respect to the sale of ordinary income assets ($4,000,000 fair market value less $3,000,000 adjusted basis) and would be required to pay $460,000 in taxes. In addition, ABC Corp. would recognize income of $1,000,000 with respect to the sale of nonhistoric long term capital gains ($2,000,000 fair market value less $1,000,000 adjusted basis) and would be required to pay $280,000 in capital gain taxes. Finally, ABC Corp. will realize income of $3,000,000 with respect to the sale of historic capital assets ($4,000,000 fair market value less $1,000,000 adjusted basis). This gain is recognized only to the extent of the percentage of the fair market value of ABC Corp. stock held by persons other than qualifying shareholders. Since 15 percent of ABC Corp.'s stock is not held by qualifying shareholders, 15 percent of the gain (.15 x $3,000,000 or $450,000) attributable to the sale of historic capital assets will be recognized by ABC Corp.

In summary, we believe that our proposal will result in the imposition of a corporate level tax on a liquidating sale or distribution of ordinary income and nonhistoric capital assets. It will also result in a shareholder tax upon receipt of liquidating distribution. However, shareholders of closely held corporations will not bear the economic burden of a corporate and shareholder level tax with respect to the direct or indirect acquisition of historic capital assets.

C. Section 333 Should be Retained in Some Form.

The Staff Proposal provided that section 333 be modified so that in the case of a complete liquidation of any domestic corporation, nonrecognition of gain may be elected by a shareholder except to the extent of any money or property deemed in section 1031(a)(2)(B) through (E) received by the shareholder in the liquidation. However, the Staff also proposed that a section 333 liquidation would result in the imposition of a corporate level tax based upon the difference between the fair market value of the property distributed and the adjusted property of such property.

As we pointed out in our testimony two years ago, the characterization of an in-kind liquidation as a taxable event may result in the distress sale of valuable business assets in order to pay federal income tax. We disagree with the Staff's conclusion that the removal of assets from a two-tax system to a one-tax system is "fraught with tax avoidance possibilities." We continue to believe that, under certain circumstances, a taxpayer should be entitled to elect treatment of a liquidation as a carryover basis transaction in a manner similar to an incorporation. Assuming that a section 333 liquidation is not either (1) used to convert dividend income into capital gain or (2) permitted to be utilized in a manner which eliminates the recognition of a corporate level tax in situations where the recipient shareholder is not subject to capital gain tax, we do not believe that any valid tax policy objective is served by its repeal.

1. Recommendation as to Section 333

We propose that, except as described below, neither an "eligible corporation" nor its "qualifying shareholders" be required to recognize any gain or loss with respect to a section 333 liquidation. An "eligible corporation" would be defined as a domestic corporation which has 35 or fewer shareholders. A "qualifying shareholder" would be any shareholder who held his stock during the lesser of the five year period ending on the date of the adoption of the plan of liquidation, or the period during which the corporation was in existence. However, shareholders that are exempt from taxation on capital gain income (such as pension funds, certain 501(c)(3) organizations or foreign persons who are not subject to United States taxation upon the receipt of capital gain income) would not be "qualifying shareholders."

The liquidating corporation would not recognize any gain or loss except to the extent of (1) recapture income and, (2) the excess of the fair market value of distributed inventory over the adjusted basis of such inventory. In addition, the difference between (a) the fair market value of the distributed assets (excluding recapture amounts and inventory gain already taken into account previously) and (b) the adjusted basis of such assets, multiplied by the percentage of shares held by persons who are not qualifying shareholders would be recognized as gain by the corporation.

A qualifying shareholder would recognize gain or loss to the extent of (1) such shareholder's ratable share of the earnings and profits of the corporation and (2) the excess of the amount of any money and the value of any marketable stock and securities received over the shareholder's ratable share of earnings and profits. Gain to the extent of the qualifying shareholder's pro rata share of earnings and profits would be treated as dividend income and gain recognized in excess of such amount is treated as capital gain. The qualifying shareholder's basis in assets received will equal such shareholder's basis in the stock surrendered, decreased by the amount of money received and increased by the amount of gain recognized.

Our proposal is designed to make section 333 liquidations the reasonable flipside of a tax free incorporation under section 351. Since any post incorporation earnings and profits would be taxed as ordinary income, any ordinary income earned during the life of the corporation's existence would be essentially taxed at the corporate and shareholder level. Moreover, the distribution of ordinary income items such as inventory would be taxable to the liquidating corporation. The preservation of a corporate level tax with respect to distributions to tax exempt shareholders ensures that either the liquidating corporation or its shareholders will ultimately pay a tax on the appreciation of assets previously held in corporate solution. Finally, the use of a substituted basis only in situations where a person is a long term shareholder is the appropriate measure of determining loss in a "disincorporation" transaction.

D. Acquisition and Mergers Proposals

Subject to our recommendations relating to sections 336, 337 and 338, we continue to support the Staff's proposal relating to the tax treatment of corporate acquisitions. We believe that "A", "B", and "C" and the triangular reorganizations should be treated under similar rules. The elimination of such difficult concepts as continuity of interest and continuity of business enterprise will result in tax certainty in the area of corporate acquisitions. The independent tax treatment of corporations and their shareholders will promote maximum business flexibility and will prevent disputes over the treatment of acquistions as taxable or tax-free.

The one aspect of the mergers and acquisition proposals which we oppose involve the establishment of "consistency" rules in the context of qualified stock and asset acquisitions. Our experience with the section 338 consistency rules indicates that they are a trap for the unwary. In addition, consistency rules would add a significant amount of complexity to a set of rules which are designed to be simple and straightforward. We are of the view that the perceived abuse which lead to the enactment of the section 338 consistency rules is more imagined than real. The ability to tailor acquisitions as mixed stock and/or asset acquisitions for maximum tax advantage is rarely a practical possibility. Therefore, we believe that the acquisition provisions should not contain any consistency provisions. The Commissioner and courts should continue to have the ability to utilize the step transaction doctrine to attack abusive acquisition techniques.

E. Shareholder Flavoring Rules are Completely Unwarranted

The Staff has proposed that if any corporation disposes of certain types of property during an "applicable period", gain from such disposition will be ordinary income. In essence, the proposal would apply to disposition of an asset within three years of the date in which the corporation acquires such asset, whether as a contribution to capital or by manufacture, purchase, etc., when the nature of the gain to certain shareholders upon the disposition of the same asset would be ordinary in nature.

We strongly oppose these shareholder flavoring rules. While section 724 provides for a "partner flavoring" rule in the case of certain contribution of assets to a partnership by a partner, partnership income is taxed only at the partner level. Moreover, for other purposes of Subchapter K, partnership tax issues such as determination of a partnership's taxable year are determined by reference to the tax circumstances of certain partners. On the other hand, the determination of the character of gain at the corporate level based upon the character of the gain at the shareholders would eliminate much of the distinction of corporations and shareholders as separate taxable entities. This provision would require a corporation to keep a constant watch upon the activities of their shareholders in order to determine the character of corporate gain. Experience has demonstrated that, with the exception of corporations with very few shareholders, it will be administratively difficult, if not impossible, for a corporation to determine whether one of its assets would be an ordinary income asset in the hands of a "substantial shareholder." Therefore, from an administrative standpoint alone, we oppose the shareholder flavoring rules.

However, apart from administrative considerations, we believe that any type of shareholder flavoring rule would be unwarranted from a tax policy standpoint. A corporation should not be required to determine the character of gain by reference to the business activities of its shareholders. Assuming that it is the efforts of the corporation which gives rise to recognition of income at the corporate level, it is inappropriate to discriminate against a corporation merely because of the unrelated activities of its shareholders. Corporations are not and should not be treated as alter egos of their shareholders for federal income tax purposes. The existence of a corporate income tax and the fact that shareholders are not taxed on undistributed corporate earnings are just two examples as to the separate tax treatment of corporations and their shareholders. A "shareholder flavoring" rule would be a major intrusion into these fundamental concepts of corporate taxation.

In the event that a corporation sells an asset shortly after a section 351 transaction and such asset would be an ordinary income asset in the hands of the transferring shareholder, section 482 and the sham transaction doctrine can be utilized to shift income back to the transferring shareholder. See National Securities Corp. v. Commissioner, 43-2 USTC ¶9562 (3rd Cir.); cert. denied, 320 U.S. 794 (1943); Stewart v. Commissioner, 83-2 USTC ¶9572 (9th Cir.). We believe that section 482 the appropriate mechanism to combat income shifting and characterization abuses. This is a much more preferable solution to a perceived problem than a shareholder flavoring rule which would be both difficult to administer and would discriminate against certain corporations solely based upon the business activities of their shareholders.

F. Conclusion

In summary, we generally support the Staff's proposed changes to Subchapter C. However, we want to reiterate our support for limited General Utilities relief for closely held corporations. We also want to reiterate our opposition to the establishment of (1) any consistency rules in the context of qualified acquisitions and (2) any form of "shareholder flavoring" provisions.

We urge the Committee to draft flexible effective dates and transition rules to implement the Subchapter C proposals. In particular, taxpayers should have the option to treat transactions which take place during the twelve month period after the date of enactment as being governed under existing law. Moreover, transactions which are presently subject to executory contracts should be governed by existing law, regardless as to the time frame in which the transaction will be completed. The reliance expectations of these taxpayers should be respected. Moreover, even if taxpayers are not presently a party to an executory contract, we feel that it will be necessary for taxpayers and their representatives to have a twelve month period to become familiar with the new system and to fashion terms designed to meet its requirement if deemed appropriate.

STATEMENT OF SAMUEL C. THOMPSON, JR., PARTNER, SCHIFF, HARDIN, & WAITE, AND DIRECTOR, GRADUATE TAX PROGRAM, IIT CHICAGO-KENT COLLEGE OF LAW, CHICAGO, IL

Mr. THOMPSON. Thank you, Mr. Chairman.

My name is Sam Thompson. I am a partner in the law firm of Schiff, Hardin, & Waite in Chicago. I am also a former professor of law at the University of Virginia. I am not appearing on behalf of any client or organization, but rather as a citizen who has an interest in tax policy.

Although I urge this committee to reject the merger and acquisition provisions of the staff's proposals, there are certain elements of the proposals that should be incorporated into present law.

It is true, as pointed out in the proposals, that current law lacks consistency and neutrality, is complex, and is subject to manipulation. But each of these concerns can be addressed in a much more direct manner than that taken by the proposals.

Further, the proposals themselves are seriously flawed in several significant policy respects:

First, as indicated in Mr. Pearlman's 1983 testimony concerning the staff's 1983 study, the proposals are themselves complex.

Second, they are subject to manipulation. For example, a corporation that is going to be liquidated could sell all of its assets for cash and then be acquired with the shareholders receiving stock of the acquire or on a tax-free basis.

Third, the proposals would erode the tax base by allowing tax-free treatment in the swap of stock in an acquisition, even where cash is the predominate part of the consideration. In this regard, the proposals run directly counter to the policy underlying the like-kind exchange provision.

Fourth, if the proposals are enacted, I believe the parties will rarely elect to have the target recognized gain in a cost-basis acquisition, because the future tax benefits arising from a step up in basis to the acquire or generally will not offset the target's immediate tax bill. Thus, notwithstanding the repeal of general utilities, virtually no corporate tax will be collected in acquisition transactions, and indeed there will be a bias to sell small corporations to larger corporations that can afford to take the carryover basis.

Fifth, the proposals lack neutrality, because the shareholder basis adjustment will be an incentive for small corporations to hold capital assets until liquidation, and for shareholders to operate multiple small corporations.

As an alternative to the proposals I suggest that the current dichotomy between tax-free reorganizations and taxable acquisitions in liquidations be retained, with the following modifications, many of which were suggested in the ABA's 1981 reorganization recommendations:

Uniform standards should apply for each form of acquisitive reorganization. There should be a minimum amount of consideration that is underlying voting common stock of the acquire or its affiliate. The minimum should be determined by reference to the permissable boot. The smaller the target relative to the acquiring corporation, the smaller should be the amount of permissable boot.

And the boot should range from 10 to 40 percent. Presently, the range is from zero to 50 percent.

Specific rules should be provided for determining the impact on the continuity-of-interest test of pre- and postreorganization sales by the target shareholders.

In order to prevent evasion of the boot-limitation rule, a reverse acquisition provision similar to the one suggested in the staff's proposal should be adopted for reorganizations. But substantially all tests for the C reorganization should be measured immediately before the reorganization, and the tests should be eliminated for the forward and reverse subsidiary mergers.

Section 351 should not be available in transactions that take the form of reorganizations.

Turning to liquidations, which were not the subject of the ABA reorganization recommendatlons:

I agree with the staff, generally, that the general utilities doctrine should be repealed. However, because of the nature of good will, and land and buildings used in the active conduct of a trade or business, such assets should not be subject to taxation at the corporate level in a partial or complete liquidating sale or distribution except for full recapture of depreciation on such buildings. This approach would permit the collapsible corporation to be repealed; but I would agree with the Senate Finance Committee proposal to recharacterize corporate gain in certain cases.

The case for not taxing good will was the strongest. It is nonseverable and nonamortizable, and to tax it would impose an unreasonably harsh penalty on liquidations. But there are also strong reasons, mainly the need to avoid the harsh penalty, for not taxing actively used land and buildings.

As a condition to the nonrecognition treatment, the parties should be required to enter into an allocation agreement. Such an agreement should help prevent the service from being whipsawed.

This alternative approach would make the law more consistent and neutral, and, further, it would address each of the 11 detailed reasons for change given in the staff's proposals.

Finally, although my statement is limited to the merger and acquisition provisions, I would like to say that I have serious doubts concerning the NOL provisions. I believe that they would allow the free transferability of NOL's where the company has significant net assets, and I think that that in itself will have a nonneutral aspect.

As Ms. Low suggested, I would prefer to see the 1976 version of 382 adopted with certain simplification modifications.

Thank you, sir.

Senator CHAFEE. Thank you very much, Mr. Thompson.

[Mr. Thompson's written testimony follows:]

STATEMENT OF
SAMUEL C. THOMPSON, JR.

September 30, 1985

STATEMENT

Mr. Chairman and members of the Committee, my name is Samuel C. Thompson, Jr. I am presently engaged in the private practice of law in Chicago, Illinois as a partner in the firm of Schiff Hardin & Waite. I also am the Director of the Graduate Tax Program at the IIT Chicago-Kent College of Law, where I teach corporate taxation. I am a former Professor of law at the University of Virginia School of Law, where I specialized in the teaching of Federal income taxation. I am the author of a law school casebook that deals with the subject of corporate taxation.*

I am not appearing here today on behalf of any client or organization, but rather as a practitioner and teacher of corporate taxation, who has an interest in corporate tax policy.

I was a member of the Tax Advisory Group to the Subchapter C Federal Income Tax Project of the American Law Institute, and in that connection, participated in the discussions that led to the ALI's proposals on Corporate Acquisitions and Dispositions.* Those proposals are the precursor of the Subchapter C Revision Bill of 1985 (the "1985 SFC Proposals" or "Proposals"). After giving serious study and thought to both the ALI Proposals and the 1985 SFC Proposals, I am here to urge this Committee to reject the essential elements of the merger and acquisition provisions of the Proposals.**

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* Thompson, Federal Income Taxation of Domestic and Foreign Business Transactions (Miche, Bobb-Merrill 1980, Supplement 1984).

My statement today is based on a paper analyzing the 1985 SFC Proposals on mergers and acquisitions*** that I have prepared for delivery at a tax symposium which will be held at the University of Virginia Law School in October. The points I present today are developed more thoroughly in that paper, which I have made available to the Staff.

A. The 1985 SFC Proposals Should be Rejected.

The approach of the 1985 SFC Proposals in classifying acquisitions as qualified asset acquisitions ("QAAs") and qualified stock acquisitions ("QSAs") should be rejected.

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* American Law Institute, Federal Income Tax Project, Subchapter C (1980).

** Although I have serious questions concerning the wisdom of the proposals regarding net operating losses, my statement today is limited to the merger and acquisition provisions.

*** "A Suggested Alternative Approach to the Senate Finance Committee Staff's 1985 Proposals For Revising The Merger and Acquisition Provisions," by Samuel C. Thompson, Jr., to be presented at the Edwin S. Cohen Tax Symposium, University of Virginia School of Law, October 18-19, 1985.

There are, however, certain elements of the Proposals that should be incorporated into present law.

The Proposals are not supported by the reasons for change given for their adoption. In critizing current law the 1985 SFC Proposals say that current law is "seriously flawed" because it "lacks consistency," is "unnecessarily complex" and is "subject to manipulation."* Also, the Proposals say that the current law needs to be more neutral, and as an example of the lack of neutrality the Proposals say present law is biased in favor of liquidations.**

All of these things are true, but each of these concerns can be addressed in a much more direct and less wrenching manner than that taken by the 1985 SFC Proposals.

Further, the 1985 SFC Proposals themselves are seriously flawed in several significant respects. First, the proposals are extremely complex. This was pointed out by the now Assistant Secretary of the Treasury Ronald A. Pearlman, in his testimony before the Senate Finance Committee's hearings on the original 1983 Staff proposals* (which were significantly less complex than the current Proposals).**

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* 1985 SFC Proposals at 37.

** 1985 SFC Proposals at 38.

Second, the 1985 SFC Proposals are subject to manipulation. For example, a corporation that is going to be liquidated could sell all of its assets for cash (possibly paying no tax because of net operating losses) and then be acquired in a QAA or QSA with the shareholders receiving stock of the acquiror on a tax-free basis.

Third, the 1985 SFC Proposals would substantially erode the tax base by significantly expanding the number of merger and acquisitions transactions that give rise to tax-free treatment at the shareholder level. Thus, the provisions would undermine the like kind exchange provision (section 1031), the purpose of which is to insure taxation on swaps of property except in very limited circumstances. Congress in the Tax Reform Act of 1984 amended section 1031 to make it clear that a swap of partnership interests does not qualify for like kind treatment. In allowing tax-free treatment on the swap of stock in a QAA or QSA where cash is the predominant part of the consideration the 1985 SFC Proposals run completely counter to this Congressional policy judgment concerning section 1031.

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* Statement of Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy, Department of Treasury, Senate Finance Committee Hearings on Reform of Corporate Taxation at 9, October 24, 1983, S. Hrg. 98-556.

** For example, the 1983 SFC Proposals did not contain a shareholder basis adjustment for the corporate level capital gains tax.

Fourth, if the 1985 SFC Proposals are enacted I predict that it will be a rare day when the parties elect to have the target recognize gain (in which case the acquiror takes a cost basis for the target's assets), because, unless the target has net operating losses, it is highly unlikely that the present value of the future tax benefits arising from a step-up in basis to the acquiror will offset the immediate tax bill that will be due from the target. This may indeed make it more likely that small corporations will be sold in carryover basis transactions (that is, the target does not recognize gain or loss and the acquiror takes a carryover basis for the target's assets) to large corporations that do not need the benefits of a step-up in basis.

Thus, in its zeal to repeal the General Utilities doctrine, the 1985 SFC Proposals may have implicitly codified and even extended the doctrine by allowing taxpayers in a cash sale of a business followed by a liquidation to completely avoid corporate level taxation of the target by completing the transaction as a carryover basis acquisition.

Further, it seems highly unlikely that any taxpayer would ever make a cost basis election without also making the special carryover election for goodwill. Thus, the 1985 SFC Proposals may, in essence, have eliminated good will from taxation in a liquidating sale, except for the uninitiated who fail to make the special good will election.

Fifth, the 1985 SFC Proposals themselves lack neutrality. The shareholder level basis adjustment for the corporate level tax on long held capital assets of small corporations (i.e., corporations with a value of less than $2 million) will be an incentive (1) for a small corporation to hold its capital assets until liquidating sale, and (2) for shareholders to rearrange corporate activities into multiple small corporations (possibly through tax-free spin-offs of subsidiaries under Code section 355) in order to qualify for the special shareholder basis adjustment.

B. Suggested Alternative Approach.

1. In General.

It is suggested, as an alternative to the 1985 SFC Proposals, that the current law of mergers and acquisitions be amended as proposed below. Basically, the current dichotomy between tax-free reorganizations and taxable acquisitions and liquidations should be retained. The reorganization definition should be revised generally along the lines suggested by the ABA Tax Section Committee on Corporate Shareholder Relationships in its reorganization recommendations,* with the incorporation of certain principles from the 1985 SFC Proposal, such as the reverse acquisition provision.

In taxable liquidations the General Utilities doctrine should be repealed except for good will and for land and buildings (except for full recapture of depreciation) that are actively used in the corporation's trade or business (hereafter referred to as "actively used land and buildings").

2. Revision of the Reorganization Definition.

a. Need for Change.

There is no tax policy justification for the disparate treatment of boot, continuity of interest and the "substantially all" test in the various forms of acquisitive reorganization. Therefore, the reorganization definition should be amended to set forth uniform standards for these items. Also, the impact on the continuity of interest doctrine of pre-and post-reorganization sales of stock of the acquiring corporation should be clarified. Further, the continuity of interest doctrine should not be subject to manipulation by having the corporation that is the real target act as the acquiring corporation in order to increase the amount of boot that can be paid. Finally, although a relative size requirement should not be adopted, the amount of permissible boot should be a function of the relative sizes of the target and the acquiring corporation.

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* American Bar Association Tax Section Recommendation No. 1981-5, 34 Tax Lawyer 1381 (1981) [hereafter cited as "ABA Reorganization Recommendations"]

b. Basic Continuity of Interest Requirement.

For each of the forms of acquisitive reorganization there should be a minimum amount of consideration that is underlying voting common stock of the acquiring corporation, or of the parent corporation of the group of which the acquiring corporation is a member, or of such other corporations as may be specified in the regulations. The minimum amount of voting common stock would be determined by reference to the permissible boot that can be used as specified below. By allowing use of stock of the ultimate parent or any other corporation specified in regulations, which is suggested by the 1985 SFC Proposals, the Groman and Bashford doctrines would be more clearly overriden.

c. Pre- and Post-Reorganization Sales.

In determining whether the continuity of interest test is satisfied, pre-reorganization sales by the target's shareholders should be disregarded, except for sales within the period two years before the reorganization to (or arranged by) the acquiring corporation. Any such sales should be considered boot. This suggestion is also made in the ABA Reorganization Recommendations.

Post-reorganization sales should be disregarded for continuity of interest purposes as long as such sales are not "pursuant to an arrangement negotiated or agreed upon prior to the [reorganization]." This is the same standard that applies under Code section 355(a)(1)(B) in the case of tax-free spin offs.

d. Reverse Acquisition Provision.

A reverse acquisition provision similar to the one suggested in the 1985 SFC Proposals should be adopted for reorganizations. Under this type of provision if shareholders of the nominal target end up with more than 50% of the stock of the nominal acquiring corporation, then the nominal target is treated as the acquiring corporation. This type of provision would prevent the evasion of the boot limitation rule, and thereby help to insure the integrity of the continuity of interest rule.

e. Permissible Boot.

Although there should not be a relative size requirement for reorganization treatment, the amount of permissible boot should be a function of the relative sizes of the target and acquiring corporation. The smaller the target relative to the acquiring corporation the smaller should be the amount of permissible boot. The minimum amount of permissible boot should be 10% and the maximum 40% as set forth in the following chart:

% of Acquiring Corporation's Underlying Voting Common Held By the Target's Shareholders As a Result of the Reorganization	Amount of Permissible Boot
Less than 5%	10%
More than 5% but not more than 10%	20%
More than 10% but not more than 20%	30%
More than 20%	40%

f. The Substantially All Test.

The substantially all test for the (C) should be measured immediately before the reorganization as suggested in the ABA Reorganization Recommendations. Also, the test should be eliminated for the forward and reverse subsidiary mergers.

g. Elimination of the Bausch & Lomb Problem.

The principle of the Bausch & Lomb case should be rejected, along the lines suggested by the ABA Reorganization Recommendations. This case holds that in a (C) reorganization where the acquiring corporation owns stock of the target, the consideration received by the acquiring corporation upon the liquidation of the target is considered as received in exchange for the target's stock rather than in exchange for the stock of the acquiring corporation.

h. General Relationship Between Code § 351 and the Reorganization Provisions.

Code section 351 should be amended to make it clear that nonrecognition treatment is not available in a Code section 351 transaction that is part of a transaction that takes the form of an acquisitive reorganization. A similar provision is contained in the 1985 SFC Proposals.

i. Incorporation of Active Trade on Business Under Code § 351 Prior to Reorganization.

Code section 351 should be amended to permit a tax-free incorporation of an actively conducted trade or business (whether previously conducted by a corporation, a sole proprietor or a partnership) prior to and in contemplation of the acquisition of the new corporation in an acquisitive reorganization. The 1985 SFC Proposals contain a similar provision, but only for corporate transferors. There is no reason for not extending the same treatment to sole proprietors and partnerships as long as the business is actively conducted. This will eliminate an artificial limitation to the form in which business is operated.

j. The Continuity of Business Enterprise and Business Purpose Doctrines.

These doctrines stand as guards against abuse of the reorganization provisions and should be retained. The essential elements of the regulations dealing with the continuity of business enterprise should be codified. The business purpose doctrine should continue in the merger and acquisition area just as it continues in every other area of tax law.

3. Suggested Tax Treatment to the Parties in a Reorganization.

a. Target's Shareholders.

The present law treatment of the target's shareholders should be basically retained. However, the suggestion in the 1985 SFC Proposals that the determination of whether a boot distribution has the effect of a dividend be made under the standard set forth in the *Wright* case should be adopted.

b. The Acquiring Corporation.

The present law treatment of the acquiror should be retained, except that section 1032 should be admended, as suggested in the 1985 SFC Proposals, to provide that a corporation does not have gain or loss upon the issuance of stock of a corporation that is in direct or indirect control of the issuing corporation.

c. The Target.

The current tax treatment of the target (*i.e.*, general nonrecognition treatment) should be retained.

4. Regular Liquidations.

a. Treatment of the Shareholders.

The shareholders in a liquidation transaction should continue to receive capital gain treatment. For reasons set out below concerning the taxation of the liquidating corporation, the collapsible corporation provisions should be repealed. The availability of Code section 333 nonrecognition treatment should be broadened as suggested in the 1985 SFC Proposals.

b. Tax Treatment of the Liquidating Corporation.

In general, I agree with the conclusion in the 1985 SFC Proposals that the General Utilities doctrine should be repealed. However, because of the nature of good will and actively used land and buildings, such assets should not be subject to taxation in a liquidating transaction, except for full recapture of depreciation on such buildings.

One reason for repealing the General Utilities doctrine for items such as inventory, portfolio shares, and land or buildings not used in the active conduct of the trade or business, is that if these items are free from tax in a liquidating sale there will be a powerful incentive to invest corporate earnings in these items in order to avoid corporate level tax on the appreciation and to convert both the appreciation and the retained earnings into capital gains at the shareholder level in a liquidating transaction. Equipment, which is now subject to full recapture of depreciation, should also be subject to full taxation in a liquidating transaction.

There should, however, be an exception to this recognition rule for the sale or distribution in partial or complete liquidation of good will (or going concern value) and of actively used land and buildings. The case for an exception for good will is the strongest (*i.e.*, it is non-severable and non-amortizable, and to tax it would impose an unreasonably harsh penalty on liquidations); but there are also strong reasons, mainly the need to avoid a harsh penalty tax on liquidating transactions, for also exempting actively used land and buildings (except for full recapture of depreciation).

The standard developed under Code section 355 for determining whether a corporation is engaged in the active conduct of a trade or business should be used in determining whether land and buildings are used in the active conduct of the corporation's trade or business. Also, as a disincentive for a corporation to invest needlessly in what purports to be actively used land and buildings, any gain with respect to any land or buildings that are claimed to be actively used but are found not to be, should be taxed at ordinary income rates. In this connection, it should be noted that the President's 1984 Tax Proposals would treat the disposition of Code section 1231 property (other than land) as giving rise to complete ordinary income.*

If a tax were imposed on good will and actively used land and buildings, there would be an unjustified bias in the tax system in favor of tax-free reorganizations, which generally involve large acquiring corporations.

Further, in order not to impose artificial restrictions on the free alienability of property held by a corporation, there should be uniform treatment of (1) ordinary sales of property, (2) ordinary distributions of property, (3) liquidating sales of property, and (4) liquidating distributions of property. This principle should also apply to good will and actively used land and buildings. Therefore, upon the partial or complete liquidation of a corporation (whether by sale of assets followed by distribution of the proceeds, or by straight distribution of the assets) the selling or distributing corporation should not have taxable gain or loss on the sale or distribution of good will or actively used land or buildings (except for full depreciation recapture).

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* The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 168 (May 29, 1985).

The shareholder should not receive a basis adjustment for the corporate level tax on long held capital assets as is proposed for certain small corporations by the 1985 SFC Proposals. The credit would be an incentive for a corporation to hold assets until liquidation and for shareholders to organize business enterprise as small corporations in order to qualify for the basis adjustment.

5. Taxation of the Target in a Section 337 Sale.

Under the approach suggested above for the taxation of the liquidating corporation, Code section 337 would be repealed and replaced with a simple provision that provides that upon the sale by a corporation of the assets of a trade or business in connection with a partial or complete liquidation, the corporation does not recognize gain or loss with respect to good will or actively used land and buildings (except for full recapture of depreciation). The collapsible corporations provision should be repealed, but a provision should be adopted, similar to that proposed by the 1985 SFC Proposals, which would determine the character of a corporation's gain on the disposition of certain assets by reference to the character the gain would have had in the hands of certain controlling shareholders.

As a condition to the nonrecognition treatment the parties should be required to enter into an allocation agreement, specifically allocating the purchase price among the assets to be sold. The agreement would have to be filed with the Service. The requirement of an allocation agreement should help prevent the Service from being whipsawed in the sale of a business.

6. Stock Purchases Under Code § 338.

I would retain Code section 338, and if the election is filed, the target should have full gain on the deemed sale of its assets, except with respect to good will and actively used land and buildings (except for full recapture of depreciation).

C. Analysis of this Suggested Approach against the Backdrop of the Reasons Given in the 1985 SFC Proposals for Change.

Each of the eleven detailed reasons for change given in the 1985 SFC Proposals* are addressed by the suggested alternative approach outlined above.

First, a uniform amount of boot would have to be used in the various forms of reorganization. Second, all of the forms of acquisitive reorganizations would have a voting common stock requirement, and, therefore, there would be uniformity in the type of consideration that could be paid. This requirement for tax-free reorganization treatment would bring the tax requirements closer into line with the requirements for a pooling of interest for accounting purposes. Third, the Groman and Bashford restraints on the use of grandparent stock in a reorganization would be eliminated.

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* 1985 SFC Proposals at 38-41.

Fourth, the forward and reverse subsdiary mergers would have the same requirements. Fifth, the "substantially all" anomaly in the (C) reorganization and forward and reverse subsidiary mergers would be eliminated. Sixth, as a result of modification of the "substantially all" concept, strip down transactions would be allowed in each form of reorganization. Seventh, any continuing uncertainty between the overlap between a (C) and (D) can easily be resolved.

Eighth, the uncertainty in the application of the continuity of interest doctrine would be eliminated by adopting specific rules governing pre-and post-reorganization dispositions of stock. Ninth, the uncertainty surrounding the parameters of the business enterprise doctrine would be eliminated by codifying the essential elements of the regulations dealing with the doctrine. I reject the notion that the uncertainty in the application of the business purpose doctrine is cause for elimination of this doctrine in the merger and acquisition context while it pervades all other aspects of the federal income tax law.

Tenth, as a result of the suggested beefing up of the continuity of interest doctrine by (1) reducing the amount of boot that can be used in a reorganization, (2) requiring a basic level of voting common stock of the acquiror as consideration, (3) eliminating the overlap of Code section 351 and the reorganization rules, and (4) the adoption of a reverse acquisition provision, the anomalies resulting from the linkage between the shareholder level consequences and the corporate level consequences should be eliminated.

Finally, the adoption of uniform standards for each form of reorganization and the clarification of the application of the continuity of interest doctrine should substantially reduce any whipsaw possibilities with the reorganization definition.

D. Summary.

In summary, the 1985 SFC Proposals should be rejected, and the Staff should be directed to develop a proposal for this Committee's consideration that would amend current law along the lines suggested here.

Senator **Chafee**. Mr. Cohen, you didn't give us your views on the net operating losses.

Mr. **Cohen**. I think the reason for that is that we have not had a sufficient expression of views from the members of the chamber. I hope that is because they are not suffering net operating losses; that is much to be desired. I will give you my own view, if I may, not speaking for the chamber:

I think it is important to do something in this area to replace the 1976 provisions. We worked on this more than 25 years ago as an advisory group to the Ways and Means Committee, and we came up with a proposal not far removed from those that are here discussed. I find the differences between what Mr. Pearlman was talking about and what the staff has been talking about to be relatively minor, and that it ought to be possible to compromise those out. It would be better, I think, to have some certainty in this.

I must say that I share the concern expressed by Mr. Pearlman today, and I am somewhat ambivalent about whether or not one should immediately repeal section 269, because unless these rules are drawn with some perfection, and it is very difficult to do so, 269 gives some protection to the Treasury and the IRS and ought to be used in rare instances, but that is a matter that I think requires some further discussion.

Senator **Chafee**. All right.

Now, Mr. Roche, you heard Mr. Faber's testimony. And Mr. Cohen, also, you heard Mr. Faber's testimony, in which he, first of all, said none of this should deter businesses from incorporating, and that small businesses are victims of the complexities of the law. He concluded that this is a big improvement, and that the possible increase in taxes—you got them as high as what? Forty-two percent, Mr. Cohen?

Mr. **Cohen**. Yes.

Senator **Chafee**. That didn't seem to deter Mr. Faber. What do you think of Mr. Faber's view? I think I know what you think of it.

Mr. **Cohen**. Well, he must have different clients than I have had in my career. In my statement, and 2 years ago, I used the same illustration. I assumed the case of a fellow who started a corner drugstore 40 years ago and bought the land and buildings at the corner of Broad and Main for $10,000, and now he is about to retire and it is worth $110,000. You can use whatever figures you want, but the point is that on this example there is $100,000 unrealized gain. Now, under current law, whether the business is incorporated or not, he pays a $20,000 tax. Under the proposal, except for the relief provision for small business that ameliorates this to some extent, he would pay $42,400. The difference would be an added $22,400, and most of my clients could afford to hire lawyers for that. I don't believe that the benefit of simplicity is worth more than double the tax, an additional $22,000. The question about collapsible corporations will exist in some cases, but it isn't going to exist for the fellow who has worked in the business for 30 or 40 years and is selling out at retirement.

Senator **Chafee**. What do you say, Mr. Roche?

Mr. **Roche**. Well, I would think that these provisions would affect that initial decision. I think you would see many more businesses formed as partnerships. The partnership has become a more familiar vehicle over the last 10 or 15 years. It offers significant tax benefits. And I think people would choose that alternative. I am not so sure that it makes sense, because in a partnership there is usually personal liability on the part of partners, particularly general partners, and I don't know that that is good as a matter of business principle.

I would also like to just say a word about complexity, and I guess maybe this is more of a personal view of mine. We have a complex tax law. We will always have a complex tax law; that's because we have a complex economy. And I think to do endless tinkering and to keep changing the Tax Code in pursuit of this elusive simplification is doing a great deal more harm than good.

Senator CHAFEE. I must say, Mr. Faber, I thought that you glided by the tax consequences when you did sell out, rather gently. We are not necessarily talking about the small businesses, because they do have this relief.

So, as far as the small businesses go, Mr. Cohen, there is this relief. I mean, $1 million dollars is $1 million.

Mr. COHEN. Yes, Mr. Chairman, but as I pointed out, the tax, instead of being $20,000 will be $28,000. I don't see any reason why the tax should be different on corporate capital gains from individual capital gains; but we are substituting, when the relief is applicable, a corporate tax of 28 percent for a present individual tax of 20 percent. That doesn't seem to me to be much of an improvement.

But, second, consider when the person dies. We have fought over this problem of carryover basis, which you will recall was enacted in the closing days of the 1976 session of Congress and was then repealed in 1980, so that now inherited assets take a basis of market value and there is no income tax if they are sold; they are subject to estate tax but not to income tax. Now, that decision was made both with respect to incorporated and unincorporated businesses alike. But the effect of this will be, in essence, to go back to carryover basis with a corporate tax rate where the business is incorporated, and not to have carryover basis for deceased persons if the business is incorporated. And I don't see the logic of that.

Senator CHAFEE. What do you say to that, Mr. Faber?

Mr. FABER. Mr. Chairman, you had said that I kind of glided by the tax cost, but obviously I am concerned about the tax cost of transactions. If other people weren't concerned about them, I wouldn't be here; I would be a music critic or something like that.

It seems to me that the kinds of changes that we are talking about here are basically the kinds of changes that result from the tax increase, and tax rates are increased all the time. As a result, transactions have different consequences that people who set up structures 15 years ago may have contemplated. I think we are used to that as part of a dynamic system, and certainly when we added the alternative minimum tax we increased the taxes on capital gains and no one got terribly excited.

It is true that we are talking about an increase in tax that would affect one form of business organization, corporations, rather than others; but, again, we have been used to having different rules for corporations and unincorporated businesses for years, and that part of it doesn't trouble me that much.

Certainly, the tax consequences of incorporation are taken into account when a decision to incorporate is made, and I would certainly be delinquent in not telling a client who is making that decision right now that, under this new set of rules, his tax on an ultimate sale of his business, should he go the taxable route, will be higher under the corporate form than if he didn't incorporate, although I would also tell him that he could sell out in a tax-free carryover-basis transaction under the corporate rules that he could not do if he did not incorporate.

But I have a feeling that when he made that decision, other factors would be much more important than the tax consequences of the ultimate sale. I just think this would be a factor, but a minor one.

Senator CHAFEE. What do you think, Mr. Thompson?

Mr. THOMPSON. I disagree with Mr. Faber, Mr. Chairman. Even if the transaction is done as a carryover-basis transaction, one of the elements of bargaining points between the purchaser and the seller is the tax benefits associated with the assets that come over. If the assets come over with a stepped-up basis, giving bigger depreciation deductions, there are going to be fewer taxes, less taxes, paid by the acquiring company. If they come over with a carryover basis, it means the acquiring company is going to pay more tax.

Any smart tax lawyer representing the acquiring company is going to take that into consideration. Any smart tax lawyer representing the selling company knows he is going to have to deal with that issue. And the tax aspects are going to be a crucial element of the bargaining, and it is going to impact on the actual consideration being paid, whether it is cash or whether it is stock.

If these proposals are enacted in their present form, I think—and I haven't been asked this question before, but I think—I would advise my clients to think very hard before incorporating. And I think that maybe it would lead me to say to them, "Hold off the decision on incorporation until you know what is going to happen, whether you know if you are going to be selling the company out or not."

Senator CHAFEE. Now, you indicated in your testimony that you thought, if these provisions were adopted, that the small companies would be encouraged to sell out to big companies, because big companies for some reason would be prepared to accept the assets at a lower basis; whereas—I am not sure of the logic, but nonetheless—a small purchaser wouldn't want to take the assets at a lower basis.

Mr. THOMPSON. This is the logic, Senator: If I am representing an acquiring company, an acquiring group, let's say a small group of folks put together to buy a company, and I am involved in representing that group, one of the things that they are going to ask me is, "What are depreciation deductions going to be? Can we amortize customer lists? What are the writeoffs we are going to be able to get?" Because those writeoffs will affect the basic economics of the deal, because they have an effect on the cash flow that is going to be generated.

Now, when the writeoffs are small relative to the amounts being paid or being asked for the target company, obviously the seller is going to be able to be in a position where he has got to pay less.

Now, for a large company, however, where the acquisition may be an insignificant portion of its overall taxable posture, it is less sensitive to the question of what the cash flows are going to be resulting from this particular small acquisition.

Senator **Chafee**. I see.

Mr. **Cohen**. Could I just add to that?

Senator **Chafee**. Mr. Cohen, you certainly can.

I must say, we have many skilled witnesses here. And if they are propounding an idea, if they can wrap it into the family farm it touches a sensitive cord here. [Laughter.]

Mr. **Cohen**. I will use a family farm incorporation. If you were the executor, say, of the deceased principal stockholder seeking to sell this——

Senator **Chafee**. A widow.

Mr. **Cohen**. Of course, and the children. [Laughter.]

Mr. **Cohen**. You would ask Mr. Thompson, as a smart lawyer, as he said, first to find a loss corporation to buy this, because the loss corporation would be happy to take over the low basis, and otherwise you would find a large corporation; but you would have to rule out individual buyers, and you probably would rule out smaller corporations.

I am concerned about those effects, which seem to me to flow from the proposal.

Senator **Chafee**. Well, gentlemen, you have been very helpful, and I appreciate your coming, each of you, and thank you very much.

The last panel will be Mr. Frank O'Connell, Mr. Arthur Hoffman, Mr. Robert Jacobs, Mr. Nicholas Tomasulo, and Mr. Richard Bacon.

All right, Mr. O'Connell, why don't you start off. And I guess Mr. Bloom is with you.

STATEMENT OF FRANK O'CONNELL, INCOMING CHAIRMAN, CORPORATION AND SHAREHOLDERS SUBCOMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC, ACCOMPANIED BY GILBERT D. BLOOM, CHAIRMAN, SUBCHAPTER C REVISIONS TASK FORCE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. **O'Connell**. Thank you, Mr. Chairman.

My name is Frank O'Connell. I am here this morning with Gilbert Bloom, and we are appearing on behalf of the American Institute of Certified Public Accountants.

The AICPA does commend the efforts of the Senate Finance Committee staff to simplify and rationalize the complex rules of subchapter C.

Senator **Chafee**. I usually find out that when they start commending the staff, it is like the judge commending the splendid argument which he reluctantly finds against.

Mr. **O'Connell**. But truly, Mr. Chairman, we do believe that many of their recommendations would reduce the complexities and eliminate some of the incongruities of the existing rules.

In particular, we support and endorse the adoption of a uniform definitional structure. However, we disagree that it is essential that the adoption of this provision be tied to the adoption of the other major components of the proposals; in fact, we believe that the uniform definitional structure could be simply incorporated within the existing framework of subchapter C.

We also acknowledge that the proposals to separate shareholder tax treatment from corporate level tax treatment and the repeal of the general utilities doctrine would produce some simplicity; however, the former proposal will not operate in the manner it is intended to operate, and the latter proposal from a shareholder's standpoint may be too great a price to pay for simplicity. Moreover, there are several new provisions that are added which will add complexity to the point where, we believe, on balance the proposals are no less complex than the existing rules.

As I indicated, the new rule for separate shareholder treatment will be simpler. However, if shareholder treatment is truly to be divorced from corporate level treatment, we think Congress should accord nonrecognition to the shareholder on a basis consistent with the rules under section 1031.

For example, under the proposals, if I own A corporation stock and I receive B corporation stock in a qualified acquisition, I will not recognize gain or loss regardless of what the other shareholders receive, regardless of what the corporate level taxation is, and regardless of whether the A business is continued. On the other hand, Mr. Chairman, if I own A corporation stock and you own B corporation stock, and we agree to exchange our interests, I will have to recognize gain or loss, irrespective of the fact that I am in the same economic position as in the former situation. Therefore, we think that if nonrecognition treatment is accorded to the first situation, it should certainly be accorded to the second situation.

Now, as far as the separate corporate level election is concerned, we think it is very attractive in theory but, as one of the other panelists pointed out, in actual practice it isn't going to work if the general utilities doctrine is repealed. And again, the reason for this is simple: no corporation is going to elect to report $1 in income today for the privilege of deducting that same $1 at some distant point in the future. The only exception we see would be acquired companies with significant net operating losses; and, until we know what the carryover rules are, we can't even be sure there.

Therefore, we think that that entire provision on the corporate election is destined to be discussed only in the classrooms, not in the boardrooms.

Now, the most troublesome provision in the entire proposals, as some of the other speakers have pointed out, in the opinion of the AICPA is the repeal of the general utilities doctrine. First of all, it is going to reverse the longstanding policy, to the effect that only a limited amount of double taxation is imposed on the sale or liquidation of a corporate business, and therefore it will reduce some corporate values.

Second, it is being considered at the same time that the President has recommended and Congress is seriously considering relaxing the double taxation rule as it applies to ongoing corporate operations.

And third, as I have already pointed out, it would render inoperative one of the key components of the entire proposals, the corporate level election.

Now, as far as relief from the repeal of general utilities is concerned, we think that the most workable alternative to be considered would be some form of corporate level exemptions as currently exists. We don't think that shareholder level relief is at all workable; it is too complex, and it is too difficult to administer. For example, it would require close cooperation between a buyer and a seller, because the seller is going to have to negotiate with that buyer for that relief as a quid pro quo for the buyer agreeing to report all of that income that he is going to have to report if he makes the election. If that is not negotiated before the closing of the transaction, and many times it will be impractical to do so, that relief will not be received, simply because, as we pointed out, that election is not going to be made.

Now, as far as the carryover of net operating losses is concerned, we would support any provision which would have the effect and permit a loss company that does truly turn itself around to use its own net operating losses against its future profits. Of the three major sets of rules that are currently being considered, we quite frankly think that the existing 54 code rules best achieve that objective, that the 76 rules are the least likely to achieve that objective, and that, depending on the circumstances, the staff proposals probably fall somewhere in between.

Therefore, as we have recommended before the Ways and Means Committee, we recommend retention of the 54 code rules with some modification to recognize that there are some inequities and some abuses that need to be addressed.

Thank you, Mr. Chairman.

Senator CHAFEE. Outside of those points, it was a splendid job the staff did. [Laughter.]

Mr. Hoffman?

[Mr. O'Connell's written testimony follows:]

TESTIMONY OF FRANK J. O'CONNELL, JR.

II. GENERAL RECOMMENDATIONS AND CONCLUSIONS

The Final Report including the Subchapter C Revision Act of 1985 ("the Act") prepared by the Staff of the Senate Finance Committee represents an ambitious undertaking to rewrite the provisions of the Internal Revenue Code dealing with corporate organizations, liquidations and reorganizations. The stated purpose of the revision is to make the tax laws in this area fairer, simpler, and less intrusive in business transactions. However, we believe that the major revisions of the Act, including the freedom to elect corporate tax consequences, the determination of shareholder tax consequences separate from corporate tax consequences and other shareholder tax consequences, and the repeal of the General Utilities doctrine are no better and perhaps worse than the existing rules they change when judged by reference to the standards of simplicity, fairness, tax neutrality, and sound tax policy. Although cloaked in the mantle of fairness and simplicity, the major revisions of the Act represent a clear choice between competing tax policies. Therefore, they should be evaluated in terms of their efficacy, additional complexity, disruption in business transactions and the administration of the tax laws, and the cost imposed on taxpayers and the Government.

Uniform definitional structure

We are in agreement with the Act's standardization of corporate reorganization definitions through the elimination of arbitrary statutory standards. The reorganization rules would become more rational and better understood by corporate executives, bankers, dealmakers, and shareholders. Complexity and the use of artificially structured transactions are reduced. Moreover, the uniform definition of control, the ability of the acquiring corporation to freely transfer assets (or target stock) within the affiliated group, and the ability of the acquiring corporation to use stock consideration of any member of the affiliated group will substantially simplify tax planning. We have long supported similar revisions, albeit within the existing structure of Subchapter C of the Code.

Separation of shareholder level tax consequences

The determination of shareholder level tax consequences on a separate shareholder basis, divorced from traditional requirements of business purpose and continuity of proprietary interest also represents a genuine simplification in the tax law and is appealing for that reason alone. However, in substance we believe the contemplated change represents an expansion of the like kind exchange provisions to include exchanges of stock and securities. Therefore its adoption should depend on the willingness of the Government to justify the deferral and potential permanent avoidance of shareholder level tax on the basis of the principles underlying section 1031. If the change cannot be justified in terms of sound tax policy, the continuity of interest requirement and other judicially-imposed reorganization requirements may have to be retained to establish the standards for shareholder level nonrecognition.

We do not believe, for reasons which we later discuss, that any expansion of shareholder level nonrecognition should be tied to a reversal of the General Uilities doctrine. The issue addressed by General Utilities, as it survives in the current law, is whether the exaction of a corporate level tax is proper on the distribution of appreciated property in liquidation. The conditions for nonrecognition on the shareholder level presents an entirely distinct issue: whether or not the shareholders have sufficiently changed their economic position by an exchange of stock or securities to merit recognition of gain or loss. Thus, we are not convinced that there is any rational relationship between this issue and the repeal of General Utilities.

Making corporate level tax consequences elective

In connection with the cost basis election, the repeal of General Utilities is antithetical to the objectives of the Act. While in form, the relative freedom to elect corporate level tax consequences represents a major innovation introduced by the Act, the election immediately loses any practical significance as a result of the Act's reversal of the General Utilities doctrine. Put simply, this reversal means that a decision to elect cost basis is premised on a taxpayer's willingness to pay a dollar of tax today to get, at most, a dollar of tax savings at some point in the future. It is clear that these terms will be unacceptable to an acquiring corporation which will be obliged to accept by default the carryover basis treatment now mandated in the case of tax-free reorganizations by current law. For this reason, the proposed corporate cost basis election as well as the existing election to treat taxable stock acquisitions as asset acquisitions now provided by section 338 will be lost.

Therefore, counter to its expressed purpose, the effect of the revision in Act will be to eliminate the existing freedom of acquiring corporations to elect to receieve a cost basis in the assets of a target corporation. As a result, cost basis elections and the complicated auxiliary provisions (e.g., consistency rules, related party exceptions, and partial carryover elections) become virtually moot. Their relevance will be confined to target corporations with loss carryforwards which may be used to offset all or part of the cost election gain.

The repeal of the General Utilities Doctrine

The principal objection to the General Utilities doctrine is the fact that it compromises the system of double taxation of corporate income by permitting gain on appreciated property to escape a corporate level tax when the property is distributed with respect to stock. Those favoring repeal often cite the repeated diminution in the scope of the doctrine caused by statutory amendments to section 311 as evidence of its inexorable decline. On the other hand, proponents of the doctrine argue that it is in appropriate to tax gain on such distributions because the distribution represents the withdrawal of the assets from the operations of the distributing corporation. They also assert that none of the statutory amendments to date call into question the application of General Utilities to liquidating distributions.

We are convinced that the debate as to whether General Utilities is a proper imposition on the concept of double taxation of corporate income will not likely be resolved through the determination of a theoretically correct answer; we suspect there is none. However, we believe that one result of repeal is clear: the passage of this

Act will result in the reduction in the value of most corporations—large and small—and of the shares in stock owned by investors in these corporations. Because cost basis generally represents a benefit to the buyer, the value of the lost benefit will be effectively imposed on the selling shareholders through a reduction in the purchase price of their shares.

In light of the substantial cost to shareholders, we believe that further reduction or outright repeal of the General Utilities doctrine should be supported by compelling evidence of distortions caused by General Utilities in existing or proposed tax laws. We believe the arguments advanced by the Report in favor of repeal (or further reduction) of the General Utilities doctrine fall far short of this standard.

First, we do not accept the logic that permitting an acquiring corporation to elect cost basis requires that such step-up be "matched" by complete recognition of gain in the target corporation's assets. Assuming, arguendo, the validity of this logic, it has either escaped notice or has been rejected by Congress for more than 60 years during which time General Utilities and cost basis have coexisted under sections 336 and 337 (and predecessor provisions). During this time, Congress has clearly supported a policy of limiting double taxation of corporate profits primarily to ongoing corporations. We find no clear policy reason to change such a long standing position. In fact, at this very time, the President is recommending, and Congress is considering, a relation of the double taxation rule as it applies to ongoing corporate operations. The President has stated in support of his proposal that double taxation discourages investors "from using the corporate form, even in circumstances where nontax considerations make it desirable." We believe that this rationale especially applies to the imposition of a double tax on the sale and liquidation of a corporate business.

Neither should repeal serve as the quid pro quo for the expansion of section 354 nonrecognition to any shareholder receiving qualified consideration. This would force all shareholders to shoulder the cost of deferral for those arranging to receive stock or securities instead of nonqualifying consideration.

We are also not impressed by the Report's recurring references to attempts by taxpayers to manipulate transactions to fall within the scope of General Utilities. The Government is well positioned to frustrate the use of the liquidation provisions and such related rules as General Utilities where not appropriate to the economic substances of a transaction.

Finally, the Report's concern with the "asymmetry" in the amount of the basis step-up of a target corporation's assets and the shareholder gain with respect to stock is misplaced. These items are simply not comparable; their relationship is of no relevance to the propriety of General Utilities. Inside basis (and thus the amount of step-up) will reflect the accumulated profits (or deficits) of the target corporation whereas a shareholder's basis in stock will be unaffected by corporate earnings. Except in the case of S Corporations, there can be no symmetry between shareholder gain and basis step-up. In fact, the amount of shareholder gain recognized over time on stock of a commercially successful corporation will generally exceed any inside basis step-up achieved as a result of deemed or actual asset purchases.

For many years, the only "symmetry" required for a corporate level step-up in basis has been symmetry of tax treatment at the shareholder and corporate levels. The policy behind this rule is that basis step-up should only occur in a taxable transaction. Congress has long supported a policy that in certain coporate sales and liquidations only one level of tax should be imposed and that tax should be imposed primarily at the shareholder level. The fact that the "price" paid for the basis step-up is inadequate or overly generous to the Government has never been releveant. As pointed out above, if measured over the life of the corporation, the "price" will almost always be in the Government's favor.

Relief from the repeal of General Utilities

We believe that any relief necessitated by the repeal of the General Utilities doctrine take the form of corporate level exemptions, an alternative which in effect preserves the doctrine. The alternative of a shareholder credit or basis adjustment is the least desirable of the relief provisions. To be properly implemented, it will cause great statutory complexity and impose greater recordkeeping and administrative burdens on corporations. Also, to achieve the desired objective of providing relief from the repeal of General Utilities, this alternative will require substantial coordination between buyers and sellers, unnecessarily delaying and frustrating corporate acquistions.

Limiting relief to small businesses

We also find the relief provided shareholders in the event of repeal of General Utilities to be inadequate in amount. the burden of repeal will fall on shareholders of corporations with a fair market value of more than $1 million, a class of taxpayers hardly affected by the proposed relief. We do not believe that relief provisions should be limtited by the fair market value of the target corporation or by other standards, such as the number of shareholders. Apart from revenue considerations, there is no reason for limiting relief from the repeal of General Utilities to certain classes of taxpayers. Such artificial rules will always be arbitrary and unfair in application. For example, is it sound tax policy to provide relief for the sole owner of a $1 million corporation and deny relief to ten shareholders each owning $1 million of stock in a $10 million corporation?

Revising the net operating loss rules

We have previously indicated in testimony before the Ways and Means select Revenue Measures Subcommittee our preference for a maintenance in revised form of the current rules (1954 version) to the adoption of the "purchase rule" in the Act. We have advocated the adoption of quantitiative standards in the form of continuation of historic levels of gross income, assets, and employees to relieve the continuity of business test from the uncertainty engendered by the absence of statutory guidelines in current law. We have also advised the consideration of additional limitations on carryforwards in the case of reorganizations.

We concede that an appealing virtue of the single purchase rule proposed by the act is its relative simplicity. However, the simplicity is only achieved by the rule's extreme arbitrariness in attrributing to all corporations a fixed amount of future profitability determined on the date of change in ownershp. The price of a loss corporation (whether measured by qualifying or nonqualifying consideration) often bears little relationship to its future income in the hands of new owners; even if the price were an accurate indicator of future profitability, it does not justify the imposition of single rate of return on date of acquistion value. the proposed law will unnecessarily restrict the absorption of operating losses or credits by successful corporations and yet be unduly generous to corporations which are not successful in the conduct of the historic business. We believe that it is obvious that the actual performance of individual corporations is a preferable basis for determining carryfoward absorption. Moreover, the single purchase rule creates extremely difficult valuation problems on tax free acquisition.

In other respects the Act's proposed rules on carryforwards are considerably more complex than those of current law. The complexity is principally created by the attempt to sweep built-in losses into the carryforward limitations. While the deduction of built-in losses may represent an occasional windfall for some taxpayers, in practice the tax benefit is already restricted by the carryforward rules because the recognition of these losses will prevent the absorption of operating loss and credit carryforwards from pre-change in ownership years. Of particular concern to us is the fact that the built-in loss limitation, where it will apply, is an open invitation to unending controversy on the types of losses covered and, in particular, the fair market value of assets including the standards by which value is determined. Past experience shows that valuation controversy is intractable, confounding taxpayers, the Government, and courts alike. We do not believe that the litigation and administrative burden that will be spawned by the built-in loss rules can be justified by arguments in favor of limiting such losses including the revenue impact on the Government. The promulgation of these rules would be another example of the triumph of theoretical purity over a practical and efficient administration of the tax laws.

The continued application of the 1954 Code limitation rules would require the retention of section 269 and the SRLY and CRCO limitations in the consolidated return regulations. The adoption of the single purchase rule proposed in the Act should eliminate the need for these section 269, and, although less clear, the need for the SLRY and CRCO limitations as well.

Because the proposed purchase rule limits loss and credit absorption to a set rate of return on a "pool of capital", we do not believe it is incompatible with the survival of carryovers in the case of investment companies. We think the special restriction for investment companies is unnecessary.

Conclusion

In summary, our support for various provisions of the act is undermined by the conclusion of the draftsmen that the complete repeal of the General Utilities doctrine is essential to the implementation of these proposals and other reforms and their failure to provide a cogent argument for that repeal. We are also concerned that on balance, the Act is no less complex than existing law. The sections eliminated have been replaced with equally obscure and arcane provisions, a few of which are outside the purview of Subchapter C.

We are also concerned that the enactment of these provisions will be unnecessarily disruptive to legitimate business transactions during the protracted period that will be required to absorb and digest the new rules. Complexity is not the bane of the corporate tax laws; uncertainty is. While the existing rules may be complex, the complexity is of long standing and judicial and administrative precedent over a sixty year period has refined the rules to the point where tax consequences can generally be predicted with reasonable certainty. In contrast, the Act will create scores of interpretative questions, new definitions, and unintended results without the benefit of regulations, rulings, and judicial precedent. The importance of professional advice and the benefits inuring to the well-advised will not be reduced by the Act.

The choice, we suspect, comes down to the retention of the existing law or the adoption of the bulk of the Act's revisions tied to the repeal of General Utilities. In this case, we would prefer the retention of existing rules rather than suffer the dual detriment of the reversal of General Utilities and the disruption and additional complexity created by this Act.

We are further concerned that these revisions are being evaluated on the basis of their effect under existing laws. Congress is presently considering tax reform proposals that would significantly modify the current tax system. If enacted, some of these reform provisions would have a profound effect on the consequences of the Subchapter C provisions, particularly on the repeal of the General Utilities doctrine. We believe that it is contrary to sound tax policy to effect changes in the long standing rules of Subchapter C until the direction of the present tax reform debate is clarly defined. Moreover, the enactment of the proposed Subchapter C revisions in the current environment of uncertainty would negate the careful and thoughtful review and analysis that these revisions have received to date.

We have attempted in the ensuing pages to identify twenty problem areas in the Act (other than in the net operating loss portion) which create unintended results, technical anomalies, and elevate formalism over substance. These problems augment our premise that the Act (as compared to existing law) will create confusion, engender controversy, and destroy predictability.

IV. TECHNICAL PROBLEMS

1. A qualified acquisition should not override section 351: Section 351(d) of the Act [1] would provide that a transfer which is a "qualified acquisition" *cannot* be a section 351 exchange. The Technical Explanation indicates that the motivation for this provision is the desire to reverse the holding in Revenue Ruling 84-71 ("the so-called National Starch type case").[2] Under the Act, whether section 351 or the "qualified acquisition" rules apply, the result would be the same because the continuity of shareholder interest requirement has been eliminated and the shareholder consequences have been "uncoupled" from the corporate consequences. Thus, the minority shareholders in the National Starch case would receive tax free treatment under the Act even if the transaction was tested as a "qualified acquisition". They also would have had tax free treatment under current law by reason of Revenue Ruling 84-71. Thus, this provision is moot as to the very type of case to which it was intended to apply.

However, we are concerned about a more conventional noncontroversial transaction which would be adversely impacted by section 351(d). If Corporation X, Corporation Y, and Individual A (all unrelated) each transfer property to Newco, and in exchange each transferor receives one third of the stock of Newco, the transaction would qualify as tax free under section 351. However, if Y effects its transfer by merger (viz., a "qualified asset acquisition"), new section 351(d) provides that Y's transfer is not a part of an overall section 351 exchange. Therefore, X, the X shareholders and A will have participated in taxable transactions. The reason for this result is that X and A will not control Newco "immediately after" the transaction and Y cannot be included in the section 351 control group. This is contrary to current law [3] and an impediment to legitimate transactions. We see no policy reason for this result.

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[1] Hereafter all references to Code sections will be to sections under The Subchapter C Revision Act of 1985 unless otherwise indicated.

[2] Revenue Ruling 84-71, 1984-1 C.B. 106 revoked Revenue Rulings 80-284, 1980-2 C.B. 117 and 80-285, 1980-2 C.B. 119. The latter rulings provided that the transfer by a less than 20 percent shareholder of his stock in Target to Newco is not under section 351 where cash was received from a third party and used to acquire the stock of the remaining shareholders.

2. Section 304 (b)(3) is emasculated: The overlap between section 304 and section 351 has been a problem for taxpayers and the Government from 1954 to 1982 when TEFRA provided for the priority of section 304, except when acquisition debt is assumed on a holding company formation. In the latter case, section 351 applies. Assume individual buys all the stock of target and incurs debt to make the acquisition. Individual then transfers the stock of target to a holding company for holding company stock and the assumption of the acquisition debt. Current law section 304(a) would normally apply to treat that debt as property which would therefore be taxable as a dividend. However, section 304(b)(3)(B)(i) provides that "in the case of an acquisition described in section 351, [304](a) shall not apply to any liability assumed by the acquiring corporation."

Under the Act, the acquisition by holding company of all the stock of target overlaps with the qualified stock acquisition rules with the latter controlling. Thus, section 351 is inapplicable (section 351(d)(1)), rendering the general section 304 rules applicable. The policy reasons behind the TEFRA changes to section 304 have been improperly vitiated.

3. Installment obligations and section 351: Under current law a taxpayer was motivated to "sell" property to his controlled corporation for an installment note since if the transfer was outside of section 351, section 453 would defer the tax and the transferee would obtain a stepped-up basis. It was to the benefit of the Government to argue that the transfer of the property was under section 351(a); although the tax would be deferred by sections 351(a)–358, the transferee would receive no basis increase under section 362(b). Section 351 of the Act taxes all debt instruments (short term or securities) as boot and section 453 applies to defer the gain to the transferor. Since the transferee will not immediately get a basis benefit for the gain that was recognized but deferred,[4] it is still to the taxpayer's benefit to argue that the transaction is outside of section 351.

Section 351(e)(2) provides that a sale of property for an installment obligation under section 453, by a shareholder who owns 20 percent of the transferee corporation after the exchange, will be treated as an exchange, under section 351. Thus, an immediate basis increase under section 362(b) will be denied to the transferee.

We are troubled by the low threshold requirement for the application of this section. The confluence of sections 351(e)(2)(B), 366(c), and 1504(a)(5) would impose the "forced" section 351 exchange when an individual merely has an option to purchase 20 percent of the stock of the transferee corporation. We believe this percentage ownership is far too low a standard. An actual 20 percent shareholder (no less an option holder who has the right to buy 20 percent) is dealing with the corporation at arm's length and the transferee corporation should not be denied a fair market value basis in the asset purchased. The case law which permitted a separate section 453 sale from the overall section 351 exchange were situations where the "sellers" of property for the installment obligation owed 100 percent of the stock of the transferee corporation.[5] Assuming that the Government has a legitimate concern in this area, the minimum stock ownership necessary to implement section 351(e)(2) should be 80 percent stock ownership without option attribution.

Another troubling aspect of this new provision is the comparative ease with which it can be avoided. Assume A formed new corporation, P and P in turn formed new corporation S. A then "sells" property to S for an installment note. P will own 100 percent of S and thus the "seller" of the installment note will own no stock of S. The seller will own 20 percent or more of P but will not be deemed to own any stock of S.[6] Having specifically legislated in this area, courts (which were not receptive to the Government's substance-over-form arguments in the past) will be loath to recast the transaction as a sale of property to P followed by a "sale" of the property to S.[7]

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[3] See Revenue Rulings 68-357, 1968-2, C.B. 144 and 76-123, 1976-1 C.B. 94.

[4] Prop. Regs. Sec. 1.453-1(f)(3)(ii) provides for a basis increase under section 362(b) as the tranferor reports gain on the installment method. Making the section 362 adjustment to basis work in tandem with the recognition of gain to the shareholder may sound good but is very difficult to implement. This is because the effect of any upward adjustment to depreciable property is spread through the remaining recovery period under a relatively complicated formula (Prop. Reg. Sec. 1.168-2(d)(3)). Where the items of property are numerous and the adjustments to basis recurring, calculation of cost recovery or gain/loss on disposition of the property becomes very difficult.

[5] *William C. Brown*, 27 T.C. 27 (1956); *Jolana Bradshaw*, 683 F.2d 365 (Ct. Cl. 1982).

[6] There are no attribution rules which are applicable.

[7] The "related party second disposition rules" of section 453(e) are only applicable if the seller owns 50 percent of P.

4. Investment company rules are too narrow: Section 354(d)(1)(A) precludes a nontaxable shareholder exchange if stock of a target corporation is exchanged for stock in an "investment company".[8] We assume this rule is intended to prevent a de facto "cashing-out" or diversification. Section 354(d)(1)(B) overrides this general rule if, target is a diversified investment company, (Section 354(e)).

We see no policy reason why the merger of a manufacturing company into an investment company or the merger of an investment company into a diversified investment company should result in taxable treatment at the shareholder level, while a merger of a diversified investment company into an investment company is proper. The direction of the merger becomes crucial in this area, contrary to the objective of the Act.[9] It appears that in section 354(a)(1) the phrase "which is an investment company" should be inserted after "target corporation". This would be consistent with existing section 368(a)(2)(F)(i) where both the target and the acquiring corporation must be investment companies, any one of which is undiversified.

5. Bias against asset acquisitions and extreme formalism required: Section 364(c)(1)(B) provides that in order for a qualified asset acquisition to take place, one corporation (or one affiliated group within the meaning of section 366(a)(5)) must acquire 70 percent of the gross fair market value and 90 percent of the net market value of the assets of another corporation. This mathematical test is computed "immediately before" the acquisition of such assets. Assume T Corporation has three active trade or business divisions, X (representing 50 percent of the value of the assets), Y (representing 25 percent of the value of the assets) and Z (representing 25 percent of the value of the assets). T has arranged for the disposition of each division to unrelated M, N, and O Corporations, respectively, solely for the stock of such acquiring corporations. If the asset acquisition route is chosen then (1) T would transfer the Y division to N for N stock which would be distributed to the T shareholders, (2) T would transfer the Z division assets to O for O stock which would be distributed to the T shareholders, and (3) the remaining assets (consisteing of the X division) would be merged (or otherwise transferred) into M for M stock (or cash) which would be distributed in complete liquidation of T.

In a carryover basis acquisition, T would not recognize gain or loss on the transfer of the X division to M nor would the T shareholders have gain or loss on the receipt of the M stock. However, the transfer of the Y and Z divisions to N and O would result in a cost basis to the acquiring corporations (N and O) and taxable exchanges by both T and the T shareholders. The latter result would accrue because the Y and Z transfers are not "qualified asset acquisitions". The X transfer is only qualified because its the last one completed at a point in time when it represents 70 and 90 percent of the assets. The sequence of transfers is paramount since only the last transfer will qualify as a merger or an acquisition under the 70–90 test computed immediately before the acquisition. Thus, if the transfer of X to M precedes the transfer of Y to N, the receipt of M stock by T is taxable to T and the T shareholders. Moreover, even if the corporate transfer sequence is appropriately arranged, the N and O stock must not reside in T at the time of X's transfer to M, but must be distributed to the T shareholders. To do otherwise would violate the 70–90 test.

This formalism is tolerable if it achieves some overall objective and is similar to a "qualified stock acquisition". However, it fails on both counts. By incorporating each division (X into New X Co, Y into New Y Co., and Z into New Z Co.) and then having M, N, and O acquire New X, New Y, and New Z, respectively, all three acquisitions are tax free "qualified stock acquisitions". Providing the acquiring corporation takes a carryover basis in the assets, the transaction would be tax free both at the corporate and shareholder level. The fact that T makes an immediate disposition of these subsidiaries does not violate control under section 351. See section 351(e)(1)(B) which provides that in determining the existence of control "immediately after", a qualified acquisition of the transferee corporation will be disregarded. A "qualified stock acquisition" merely requires the acquisition of 80 percent of the stock of a corporation within a 12 month period and is not conditioned on the length of the corporation's existence.

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[8] An investment company is a regulated investment company, a real estate investment company, or a corporation 50 percent of the value of whose assets is stock or securities (80 percent of which is held for investment). This is similar to the current definition.

[9] "In short, current law permits taxpayers to structure economically equivalent transactions in a variety of ways, sometimes with dramatically disparate tax consequences. This flexibility operates to the benefit of the well advised, but to the detriment of the ill advised. No policy justification can be found for this outcome." The Subchapter C Revision Act of 1985 (May 1985) (hereinafter referred to as the "Act") p. 46.

Therefore, dramatically different consequences arise dependent upon whether the transaction is structured as an asset or a stock acquisition. This is contrary to one of the announced objectives of the Act.[10]

6. Parent and subsidiary acquired in an asset acquisition: Section 354(a) provides that in a qualified asset acquisition the shareholders of target who exchange stock of target for stock of the acquiring corporation, have tax free treatment. Since the shareholders of target must be direct shareholders section 354(c) provides that a current law "B" reorganization/"C" reorganization overlap[11] the "C" reorganization rules control to permit Parent's shareholders to receive tax free the stock of the acquiring corporation. If the "B" rules controlled ("qualified stock acquisition") then only Parent could receive acquiring stock tax free.

The simultaneous acquisition of Parent and its wholly owned Subsidiary for an acquiring corporation's stock in dual qualified asset acquisitions should permit the shareholder of Parent to receive the acquiring corporation's stock tax free under section 354. This should be true for both the qualified asset acquisition of Parent as well as the qualified asset acquisiting of Subsidiary. Existing case law provides for this result.[12] In addition to section 354(c), the Act should provide that in a qualified asset acquisition of both Parent and Subsidiary, Parent's shareholders can be the section 354(a) recipient of the acquiring corporation's stock with respect to the Subsidiary acquisition. This change would be consistent with section 364(e)(2) which provides that in a simultaneous qualified asset acquisition of Parent and Subsidiary, the Subsidiary stock is excluded as an asset of Parent in computating the 70-90 test for Parent.[13]

7. Upstream merger: liquidation or qualified asset acquisition: Assume P Corporation purchases 60 percent of the stock of T Corporation. Ten months later, T merges into P. Is the transaction a qualified asset acquisition to which a cost basis election can be made? Section 365(d)(4)(B)(i) provides that in determining whether an acquisition is from a related party (precluding cost basis) stock of T acquired within 12 months from an unrelated party is disregarded. The Technical Explanation[14] provides for a qualified asset acquisition for which cost basis is available if in the facts of the above example T merges into S, a wholly owned subsidiary of P. However, if T merges into P (with the minority shareholders receiving P stock) will the prior stock purchases be disregarded (which would provide for a qualified asset acquisition at cost) or will the prior stock purchases be recognized and the upstream merger denied qualified asset acquisition status because P received 60 percent of the assets in its status as a distributee in liquidation (section 364(c)(3)?[15] If the latter result accrues, section 354 treatment is denied to the shareholders of T.

Under current law the minority shareholders of T would receive nonrecognititon treatment (regardless of whether the 60 percent purchase was "old and cold".).[16] There is no policy reason to deny similar treatment under the Act.

8. Overlap of section 311 and a qualified stock acquisition: Assume X Corporation owns 100 percent of Y Corporation and Y owns 100 percent of Z Corporation. A distribution by Y of all the stock of Z to X triggers gain under section 311(a).[17] However, under section 364(b) the transaction is also an acquisition by one corporation of control of another within a 12-month period and thus would constitute a qualified stock acquisition. As a qualified stock acquisition the transaction is not a "distribution" of property with respect to stock which would trigger a section 311(a) gain.

The latter result is buttressed by section 364(c)(3) which provides that "a qualified asset acquisition shall not include a transaction in which a corporation acquires assets pursuant to a distribution." Having excluded an asset, but not a stock acquisition the presumption is that a qualified stock acquisition can co-exist or supplant the distribution rules. There is a clear conflict. Thus, on the distribution of Z stock by Y it appears that Y could legitimately maintain that no section 311(a) gain arises.

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[10] see fn. 9, supra.

[11] P Corporation whose only asset is 100 percent of the stock of S Corporation merges into an acquiring corporation for the acquiring corporation's stock.

[12] *William H. George*, 26 T.C. 396 (1956) Acq., Revenue Ruling 68-526, 1968-2 C.B. 156.

[13] However, the acquiring corporation's stock issued in the qualified asset acquisition of Subsidiary is not excluded as an asset of Parent in determining whether Parent must re-transfer that stock back to the acquiring corporation followed by a meaningless resissuance of new acquiring corporation stock ultimately to be distributed to the Parent's shareholders.

[14] Act, page 231.

[15] See: Bausch & Lomb, 267 F.2d 75 (2nd Cir. 1959); Revenue Ruling 54-396, 1954-2 C.B. 147; and Revenue Ruling 69-294 1969-1 C.B. 110.

[16] Forty percent is sufficient for continuity of interest under current law. See *John A. Nelson Co.* v. *Helvering*, 296 U.S. 374 (1935).

[17] This is based on the assumption that the distribution neither qualifies under section 355 nor meets the requirements of section 311(d) (nonrecognition of gain at the corporate level on the distribution of stock of a corporation controlled by the distributor for 5 years).

9. Qualified asset acquisition: Beating the related party prohibition: A qualified asset acquisition requires the transfer of 70/90 percent of assets and a liquidation of the Target corporation. The Technical Explanation further qualifies the acquisition by providing the following:

"In contrast to the definition of a qualified stock acquisition which specifically permits creeping acquisitions of stock during a 12 month period, the qualified asset acquisition requires an acquisition of assets in a single transaction. Thus, in general a creeping acquisition of assets will not qualify as an asset acquisition. It is anticipated, however, that in unusual cases a closing of a single acquisition may extend over several days." [18]

A qualified asset acquisition will be denied cost basis treatment if it is a related party acquisition under section 365(d). For these purposes the qualified acquisition rules are "loosened up" for determining whether a qualified asset acquisition is a related party transfer. Thus, the 70/90 percent test is replaced with a "substantially all" test and the liquidation requirement of section 364(c)(2) is deleted. It appears, however, that by merely "selling" 50 percent of the assets to the acquiring corporation in one transaction and selling the balance a number of months later, the qualified asset acquisition rules (including the rules as relaxed for related party acquisitions) will be avoided and cost basis can be obtained. The "step transaction" doctrine appears inapplicable due to the elimination of "creeping asset acquisitions."

10. Taxpayer gets whipsawed on relaxed qualified asset acquisition rules: A qualified asset acquisition by a related party cannot result in a cost basis acquisition. For these purposes the determination of a qualified asset acquisition is relaxed to "sweep in" more transactions to which cost basis will be denied. However, notwithstanding the mandatory imposition of carryover basis, the "relaxed qualified asset acquisition" is still not a "qualified asset acquisition" which will protect the target corporation and its shareholders. Thus, consider the draconian result accruing on the transfer by target of all its assets to a 50 percent owned acquiring corporation solely for acquiring corporation stock which is distributed to the target shareholders in 13 months. Although the acquiring corporation must take a carryover basis in the assets, gain or loss will be recognized to target and the target shareholders on the distribution of the acquiring corporation's stock. At least under current liquidation-reincorporation principles, in order to deny a step-up in basis to the acquiring corporation, the Government had to renounce gain or loss the the target corporation and to the target shareholders with respect to "qualified consideration".

11. Mandatory cost basis and foreign corporations: We question the rule in section 365(f)(3)(B) which provides that a qualified asset acquisition of target (domestic corporation) by acquiring (foreign corporation) must result in a mandatory cost basis election and concomitant gain or loss to target under section 361(b)(1). This provision usurps the role of current section 367(a)(3)(A) which would permit nontaxable treatment on the transfer by a domestic corporation of assets to a foreign corporation where the transferee is in the active conduct of a trade or business outside of the United States. Thus, section 365 and 367 work at cross purposes.

12. Carryover basis exception to the consistency rule is too narrow: The general consistency rule mandates cost basis if: a) there is a qualified acquisition of a target corporation, b) an asset is acquired by the acquiring corporation during the consistency period, and c) such asset, along with the assets of target, were in the same corporation at any time during the consistency period. The purpose of the rule is to demand the consistent treatment of assets previously held in the same corporation.

Section 365(c)(2)(A) in furtherance of the goal of consistency permits carryover basis for all assets acquired if: a) target is acquired in a qualified acquisition to which carrovery basis is applicable, and b) the "asset" (referred to above) is acquired in a qualified acquisition to which carryover basis is applicable. We believe that this exception is too narrow and is inconsistent with the purpose of the consistency rules.

Assume P Corporation owns two groups of assets (X and Y). Within the consistency period, all the X assets are transferred to new subsidiary (S), S is acquired in a qualified stock acquisition with carryover basis by Q corporation. Lastly, P and Q under section 351 jointly create new subsidiary (R) to which P transfers Y assets and Q transfers cash. In return P receives 20 percent of R and Q receives 80 percent of the R stock. R takes a carryover basis in the assets which is consistent with the carryover basis Q received in the X assets. While the purpose of the consistency rules is not violated (all assets have carryover basis), section 365(c)(2)(A) is not applicable and mandatory cost basis results. The phrase "qualified acquisition" in section 365(c)(2)(A)(i) should be eliminated since as long as carryover basis applies on the receipt of the assets the transaction should not have to be a "qualified acquisition".[19]

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[18] Act, page 224.

We believe the clear policy as indicated in the Technical Explanation [20] is to provide a consistent cost or consistent carryover basis. The statutory language should be revised to reflect this principle.

13. Direction of merger counts: Formalism beats the consistency rules: For the past 13 months P Corporation has owned 60 percent of the stock of T Corporation (a corporation with a current operating loss). P is now desirous of gaining 100 percent control of T and also deriving a cost basis for some of T's assets and a carryover basis for the balance of the assets. Thus, the following transpires: T sells the desired cost basis asset to P, T's gain is offset by the operating losses of T, and P receives a step-up in the basis of the assets. P then creates Newco and merges Newco into T (T surviving) for cash or stock which is distributed to the T shareholders in exchange for their remaining 40 percent of T. As a result of the transaction P has acquired 40 percent of T but the transaction is not a qualified stock acquisition since 80 percent of T stock was not required within a 12 month period. Section 365(c)(1) and Section 365(c)(4) cannot apply.

If T had merged into Newco (Newco surviving) for cash and stock which would be distributed to the T shareholders, the transaction would have been a qualified asset acquisition and cost basis would have been mandated by section 365(c)(1). Under current law the consistency rules of section 338 would not be applicable regardless of the direction of the merger.

14. Section 355, security holders, and dividend treatment: The language in Section 356(b) has been modified to specifically make a "security holder" who receives nonqualifying consideration in a Section 355 distribution the recipient of a Section 301 dividend. It should be made clear that since a security holder never has any ratable share of earnings and profits, section 301(c)(1) will be inapplicable to such security holder.[21]

15. Boot treated as a dividend: Section 356(d)(3) provides rules for the determination of whether nonqualifying consideration distributed to the shareholders on a qualified acquisition has the effect of a dividend distribution. The shareholders of target will be deemed to have exchanged all their target stock for an equivalent value of acquiring stock and then the stock of the acquiring corporation (commensurate with the value of the nonqualifying consideration) will be construed to be redeemed under section 302. The *Wright* [22] case has been adopted as the standard with the result that the "before test" percentage under section 302 will be after the target shareholder's have been deemed to exchange all their target stock for acquiring corporation stock. The "after test" percentage will be the actual percentage of stock owned by such shareholder in the acquiring corporation.

While we believe the present IRS rule [23] is flawed by its failure to take cognizance of the existence of the acquiring corporation and the target shareholder's relationship to such corporation, we are only slightly more enamored with the *Wright* case. Both the current and the porposed rules are subject to manipulation by the ability to change the acquiring corporation (viz., the direction of the merger can be of paramount importance).

Under the Act if X merged into Z corporation for stock and cash which is distributed to the X shareholders, the "before test" is after the X shareholders are integrated into Z's corporate structure and are hypothetically in receipt of more acquiring stock than they actually end up with. However, if Z merges into X, with the receipt of X stock by the Z shareholders followed by the distribution of cash to the orginal X shareholders in exchange for X stock the "before test" is before any part of the transaction and the "after test" is after the integration of the Z shareholders.[24] This technique is manipulative and should not be aprt of any Act that seeks to root out unnecessary formalism.

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[19] We assume that for purposes of the consistency rule, Q and R are treated as one corporation under section 366(a)(5)(B). To conclude otherwise would leave a "gaping loophole" in these rules.

[20] Act, page 230, example xiii.

[21] See, Revenue Ruling 71-427, 1971-2 C.B. 183, where section 356 "boot" to a security holder is always capital gain.

[22] *Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973).

[23] Revenue Ruling 75-83; *Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978).

[24] Revenue Ruling 75-447, 1975-2 C.B. 113.

The correct test is the comparison of the shareholder's percentage interest in the target corporation before any part of the transaction and the "after test" would be the percentage interest that such shareholders end up with in the acquiring corporation. This would result in a complete reversal of the "automatic dividend rule" in 1945 [25] to a near "automatic capital gain rule" in 1985. However, we believe that this is the intellectually pure answer, the result consistent with the Zenz doctrine,[26] and the result that will transpire under Wright in any situation where the acquiring corporation is equal to or larger than the target corporation (even where the distribution of boot is pro rata among the target shareholders). Only where a shareholder owns more than 50 percent of the acquiring corporation after the transaction will dividend treatment result.

We further question the requirement in section 356(d)(3) that the boot dividend equivalence test be determined only on the acquisition date. Under current law where shares are disposed as part of the plan (by commitment or otherwise) the disposition should be integrated into the determination of the true "after' test. In a public context where the cash portion of an acquisition is over-subscribed, and such shareholders are forced to take less cash than they wanted, it is proper to permit the shareholder to avoid the dividend treatment that would otherwise accrue by disposing of shares in the market place. The "after test" should be after this disposition.[27]

16. Section 356 and the attribution rules: Current law provides that the effect of a dividend under section 356(a)(2) will be determined with the use of the section 318 attribution rules. In determining whether a section 356 exchange exists, a shareholder must participate in a section 354 exchange. General wisdom holds that a shareholder must actually participate in such section 354 exchange. The attribution rules cannot be used to make a shareholder a section 354 participant.[28]

The proposed revision to section 356 appears to have changed this result. Section 356(c)(2) permitting the recognition of loss implies that the exchange of a shareholder or security holder who does not receive qualifying consideration falls within section 354. Section 356(d)(1), in turn provides that where dividend treatment is appropriate, section 356(c)(2), is inapplicable. This implies that the attribution rules can be used to tax the receipt of solely nonqualifying consideration as a dividend. If the effect of revised section 356 is to change the law, it is not clear whether this change was in fact intended.

Clarification is also needed in section 356(d)(1)(B) as to the use of the attribution rules in determining a "shareholder's ratable share of earnings of profits," and section 356(f)(2) relating to the exchange of section 306 stock not being treated as a dividend if a shareholder receives no qualifying consideration.

17. Section 311(d) is too restrictive: We question the need for the limitations placed on the tax free distribution of stock of a controlled subsidiary. As a result of these limitations, gain would be recognized if the distributing corporation did not have control of the subsidiary during the five-year period preceding the date of distribution or if within that period the distributing corporation had contributed a substantial part of the assets of the subsidiary, section 311(d)(1) and (2).

Because revised section 311 (and its repeal of General Utilities) would ultimately tax the full amount of appreciation on assets removed from corporate solution, the above limitations are rarely necessary to protect the Government from avoidance of corporate level tax. We agree that under proposed section 311(d), the acquisition of control and subsequent distribution of the controlled subsidiary may in certain circumstances constitute unwarranted tax avoidance for which recourse to section 311(d) should be denied. The proper test would be whether both transactions occur pursuant to a prearranged plan. By contrast, the proposed limitations will apply to many acquisitions not motivated by tax avoidance and will serve to frustrate the purpose of section 311(d).

Section 356(e) of the Act provides that a controlling corporate shareholder of a target corporation which receives nonqualifying consideration in a qualified acquisition will avoid gain in a carryover basis acquisition if such corporate shareholder liquidates within 12 months. Like section 311(d), section 356(e) is intended to prevent a double corporate level tax. Section 356(e), however, lacks the limitations found in section 311(d). This means that where the distribution occurs in connection with a qualified stock acquisition, the section 311(d) limitations can be easily avoided (as shown below) by arranging the order of the related transactions. This is another situation where the tax consequences under the Act can be more arbitrary and subject to manipulation than those occurring under current law.

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[25] *Zenz* v. *Quinlivan*, 213 F.2d 914 (6th Cir. 1954).
[26] *CIR* v. *Bedford's Estate*, 325 US 283 (1945).
[27] Revenue Ruling 77-226, 1977-2 C.B. 90; GCM 39290 (January 4, 1984).
[28] Revenue Ruling 74-515, 1974-2 C.B. 118.

Assume that Controlling Corporate Shareholder X owns all the stock of T Corporation to be acquired in a qualified stock acquisition by P Corporation. At the date of the acquisition T will have been controlled by X for three years. The acquisition will be solely for nonqualifying consideration and no cost basis election will be made. If X first liquidates, distributing all of its assets to its shareholders, there would be taxable transactions at both the X corporation level (on distribution of appreciated assets including T stock) and at the shareholder level equal to the appreciation in X shares on the liquidation of X followed by the exchange of T for P stock. On the other hand, if the qualified stock acquisition were to occur before the liquidation, there would be no corporate level tax on T stock under section 365(e) and any shareholder level tax would again be based on the appreciation of X shares. The reversal in the steps of the above two examples produces very different tax consequences. (Section 1020 which bases X's basis in T on T's net inside basis and section 362(b)(3) which sets T's basis in qualifying and nonqualifying consideration at the fair market value of the consideration might also independently permit avoidance of controlling corporate shareholder gain with respect to the nonqualifying consideration.)

18. Section 1257: A back door reinstatement of the collapsible rules: If any salubrious effect results from this Act it is the repeal of the collapsible corporation provision of current law section 341. These rules have been an enigma to the taxpayer and the Government. Thus, it is incredible to find that these provisions have not been eliminated but merely reincarnated in section 1257. On a corporate sale of assets section 1257 converts capital gain to ordinary income where property is manufactured, constructed, produced, purchased or otherwise acquired by any corporation if a "substantial shareholder" would have ordinary income if it sold the assets. This is a reinstatement of the "hypothetical sale" rules of section 341(e) without the taxpayer escape clauses of section 341(b), (d), (e), and (f). We find the whole provision objectionable based on its arbitrariness (no exceptions); pervasiveness (it is applicable to all transactions including minor sales of assets, not just transactions under existing section 341); ill-defined terms (substantial portion); formalism (qualified stock acquisition avoids section 1257 whereas qualified asset acquisition does not); irrelevance (not part of any Subchapter C "reform"); and wastefulness (litigation on the effect of hypothetical sales by shareholders is likely to be commonplace).

19. Basis rules too broad: Section 358(b) provides that the basis of nonqualifying consideration received in a section 351, 354, 355, 356 or 361 exchange shall be the fair market value of such property at the time of exchange. Section 361 should be dropped from this list. Section 362(b)(2) provides the exclusive source for determining target's basis in qualified and nonqualified consideration (i.e., fair market value).

20. Section 1020 is unjustified: The stated purpose of section 1020 is the avoidance of double counting of gain or loss and of "discontinuities" resulting from the decision to sell stock rather than assets of a controlled subsidiary. The arguments in favor of the provision are not convincing: its most apparent effect is to force a recognition of phantom gain or to allow the recognition of phantom loss.

Assume P Corporation acquires all of the stock of T Corporation in a qualified stock acquisition. T's net inside basis (viz., net worth under tax accounting principles) is $1 million but due to its demonstrated earnings potential and value as a going concern, T is worth $2 million which is the purchase price paid by P. Because the appreciated intangibles are nonamortizable, the recapture costs of a cost basis election exceed the future benefit of basis step-up and no such election is made. T is sold five years later, and because interim earnings and profits have been distributed to P and there is no further appreciation in T's tangible and intangible assets, the selling price is again $2 million. Under section 1020, P would have been forced to reduce its basis in T to T's net worth of $1 million in order to achieve "basis conformity". On the subsequent sale, P would recognize income of $1 million despite the fact that in economic terms no gain would have been realized.

On the other hand, if the net inside basis of T were $2 million but the acquisition price, $1 million due to depressed earnings, P would recognize a loss of $1 million on disposition of T even though it had recovered through the selling price its entire investment in T.

We are not impressed by the claimed discontinuities between asset and stock sales. The freedom to sell stock rather than assets is not an unwarranted benefit but an integral element of the system of double taxation of a corporation and its shareholders. Moreover, the sale of stock and the sale of assets are not economically identical transactions in that the selling price for controlled subsidiary stock will be different than the selling price of the subsidiary's assets because, inter alia, the existence of carryover basis and other attributes will affect the price of the stock. Finally, when in the usual case the controlling corporation and controlled subsidiary file a consolidated tax return, gain or loss on the disposition of assets will result in an adjustment of roughly similar amount to the basis of stock of the controlled subsidiary. This adjustment will make the amount (if not the character) of gain or loss on the disposition of assets followed by the disposition of the stock equivalent to the one-step disposition of the stock. While the possibility of loss in basis under section 332 may change this result, the phenomenon of disappearing basis does not warrant any particular respect as a matter of tax policy.

The adjustment of the premium and discount accounts envisioned in section 1020 (in the event the stock is disposed of before the end of the third taxable year following the control date) is no more defensible than the elimination of these accounts altogether after the end of the third taxable year. The net result is the same: and unwarranted loss or increase in basis in the stock of the controlled subsidiary.

Even were we to agree with the objectives of section 1020, the required adjustments to premium and discount may be impossible to calculate. The calculations would require a review of perhaps a thouands of asset dispositions in order to adjust premium and discount accounts. And because in a carryover basis acquisition subject to these rules date of control appraisals may not be available (because of the possibility that the acquisition will be accounted for as a pooling rather than a purchase), the taxpayer will be hard-pressed to distinguish between pre- and post-control date changes in value. Finally, the types of disposition of assets triggering the adjustments are wholly unexplained. Will the turning of inventory constitute a disposition of an asset? A similar question can be posed with respect to the depreciation of fixed assets or amortization of intangibles, the deduction of accrued expense not recognized for tax purposes on the control date, or other items of tax accounting. The existence of premium and discount at the date of acquisition will be as much influenced by these items as by unrecognized appreciation or depreciation in assets which are later the subject of outright disposition.

The reasons advanced in favor of proposed section 1020 describe the determination of basis under the existing consolidated return regulations as complex and continuing. The proposed rules are even more complex and no more premanent than those under the consolidated return regulations. Aside from the initial adjustments to premium and discount accounts, Section 1020 requires that a controlled subsidiary maintain balance sheets prepared under tax accounting principles. Few corporations do this at present and the task would not be easily implemented. By contrast, annual adjustments to basis now required under the consolidated return regulations are more easily accomplished. Moreover, the statement in the Reasons for Change notwithstanding,[29] the annual adjustments for earnings and profits closely follow changes in the net inside basis of a controlled corporation, the principal difference arising in accounting for depreciable property.

We are in agreement with the proposal insofar as it eliminates the reference to carryover basis to establish the basis of stock in a controlled subsidiary acquired for qualifying consideration. The uncoupling of corporate and shareholder tax consequences means that normal cost basis rules should apply whether the consideration is qualifying or nonqualifying consideration.

STATEMENT OF ARTHUR S. HOFFMAN, CPA, CHAIRMAN, TAX EXECUTIVE COMMITTEE, NEW YORK STATE SOCIETY OF CPA'S, NEW YORK, NY, ACCOMPANIED BY WALTER M. PRIMOFF, CPA, DIRECTOR OF TAX POLICY, NEW YORK STATE SOCIETY OF CPA'S, NEW YORK, NY

Mr. **Hoffman**. I am Arthur S. Hoffman, a CPA, and I am representing the 28,000-member New York State Society of CPA's. I am chairman of the executive committee of the society's tax division, and I am accompanied by Walter Primoff, who is the director of tax policy of our State society.

Senator **Chafee**. I am glad you are here. And Mr. Bloom, we welcome you, also.

Mr. **Hoffman**. And we thank you for the opportunity to appear.

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[29] 29 Act, page 46.

I am going to compliment the staff too, and do exactly as you figured I would do.

The society enthusiastically favors thoughtful simplification of complex areas in the code, and accordingly we offer our highest praise to the Senate Finance Committee and its staff for the effort and care underlying the final report on the Subchapter C Revision Act.

Nonetheless, tax proposals, including those now before us——

Senator CHAFEE. Didn't you say you "generally" supported the staff proposals in your testimony?

Mr. HOFFMAN. The area of concentration of the testimony is going to be in a particular area which has been voiced before. In our paper that we presented, we have a long list of areas that we do support.

Senator CHAFEE. Oh, you do support the NOL staff proposals?

Mr. HOFFMAN. That is correct. Yes.

Senator CHAFEE. OK, now, let's get to General Utilities.

Mr. HOFFMAN. OK.

Now I say that, nonetheless, certain provisions are going to have some impact upon taxpayers that might not readily be foreseen, and we wish to point out:

The society believes that legislation of this kind, which is to simplify an area of the code and remove its inconsistencies, is generally thought by Congress and the public to be technical in nature. It is assumed not to impose new levels of taxation, which would fall hard upon small businessmen who more and more have become the legitimate concern of Congress in the present and past administrations. But the society believes the proposals will impose new levels of taxation, which will be applied with harsh and too often discriminatory consequences to those engaged in closely held businesses, who, by reason of age and lack of family successes or threat of competition from larger companies, choose finally, after many years in business, to sell out or close up. And in that respect, I don't see much of a difference between "selling the business" and "liquidating the business."

As a practical matter, the value of all closely held businesses will decline upon passage of the proposals, and it is the total repeal of the General Utilities doctrine which is going to have this effect.

Heretofore, the sale or liquidation of the business as a general rule would result in a single tax at capital gains rates at the shareholder level. This has been true whether or not the owner sold his stock or the incorporated business sold its assets and proceeded within a 12-month period to liquidate. The purchaser of the stock or assets could apply his costs to the assets acquired, normally without a tax imposed at the corporate level on the appreciation of assets. Consequently, the selling shareholder realizes the value of his company without offset by any tax imposed at corporate level on appreciated assets.

It is important in analyzing the economic impact of the proposals, and the extent of the reversal of past tax policy, to realize that the tax at corporate level resulting from the election to step up the basis of the corporate assets or the recognition of gain on their sale will fall squarely upon the selling shareholder and not upon the usually larger, stronger, and often public acquiring company. The shareholders of closely held businesses would be treated without favorable distinction from the investor or speculator in public companies who sells stock and is taxed at capital gains rates, assuming a holding period of anything more than a mere 6 months.

The owner of the closely held business who is the subject of our concern—and this is something that you predicted would be said—is the risk taker, the lifelong stimulator of local business, the job producer, and in essence the backbone of the American economy. The taxes applicable to his termination of business may fall upon gains accruing over several decades. We do not believe that his situation should be correlated in Congressmen's minds and under the Internal Revenue Code with the investor or speculator in public securities. We believe that any dichotomy of treatment accorded today is based upon the merits as a matter of tax policy.

The society believes that the proposals' effort to mitigate the damage from extinguishing the General Utilities doctrine, as represented in sections 336, 337, and so on, is wholly inadequate. The proposals purport to provide relief in a liquidation or liquidating sale from double taxation of gains on long held capital assets, those held for more than 5 years, which are owned by small businesses, those with stock valued up to $1 million.

The method chosen, proposed section 1060, is to permit shareholders generally to adjust the basis of their stock by the amount of gains subject to tax. The society believes that this relief provision is excessively restrictive and will not adequately reach the fundamental issue, that the proposals impose a new level of taxation upon owners of closely held businesses. So, we recommend three things:

Reconsideration of the imposition of double taxation on transactions presently subject to single-level of tax treatment accorded by sections 337 and 338, and in the case of liquidations under section 336;

Expansion of the relief provision which is now limited by the million-dollar description of small businesses, and expansion of the discription of the gains which will entitle the shareholder to a basis adjustment now limited to gains on long-held capital assets. We believe that a study should be made to determine whether small businesses entitled to relief should be measured by the number of shareholders, for example, 35; the value of stock, in which case the values should be higher than appears in the proposals; the public or private nature of the corporation; or otherwise; and last,

Protection from double taxation of shareholders who formed corporations by the transfer of appreciated property, at least to the extent of the pretransfer appreciation.

Thank you very much.

Senator **Chafee**. Thank you very much, Mr. Hoffman.

Mr. Jacobs.

[Mr. Hoffman's written testimony follows:]

STATEMENT OF THE
NEW YORK STATE SOCIETY
OF
CERTIFIED PUBLIC ACCOUNTANTS

HEARINGS BEFORE
THE SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE

ON

PROPOSALS TO REVISE
SUBCHAPTER C
OF THE
INTERNAL REVENUE CODE

SEPTEMBER 30, 1985

II. GENERAL COMMENTS

REPEAL OF SECTION 337

The Society believes that legislation of this kind — to simplify an area of the Code and remove inconsistencies — is generally thought, by Congress and the public, to be technical in nature. It is assumed not to impose new levels of taxation which would fall hard upon small businessmen who more and more have become the legitimate concern of Congressmen and the present and past Administrations.

The Society, however, believes that the Proposals will impose new levels of taxation which will be applied with harsh and, too often, discriminatory consequences to those engaged in closely-held businesses who, by reason of age, lack of family successors or threat of competition from larger companies choose finally, after many years in business, to sell out or close up.

As a practical matter, the value of all closely-held businesses will decline upon passage of the Proposals, as explained below. It is the total repeal of the General Utilities doctrine (General Utilities and Operating Company v. Helvering, 296 U.S. 200 (1935)), and its relationship to non-recognition of corporate gain, as it is currently set forth in Section 337, which would have this adverse effect.

Heretofore, the sale or liquidation of the business, as a general rule, would result in a single tax at capital gains rates at the shareholder level. This has been true whether or not the owner sold his stock or the incorporated business sold its assets and proceeded within a 12-month period to liquidate.

The purchaser of the stock or assets could apply his cost to the assets acquired, normally without a tax imposed at corporate level on the appreciation of assets. Consequently, the selling shareholder realizes the value of his company without offset by any tax imposed at corporate level on appreciated assets.

It is important in analyzing the economic impact of the Proposals and the extent of their reversal of past tax policy to realize that the tax at corporate level resulting from the election to step up the basis of the corporate assets or the recognition of gain on their sale will fall squarely upon the selling shareholder and not upon the usually larger, stronger and often public acquiring company. We will see a new factor taken into the negotiations to set the price: the tax on recognition of the appreciation of assets. Furthermore, the negotiations will have to extend to pricing each of the assets, since appreciation of ordinary income assets in contrast to capital assets would substantially affect the taxes which would be borne by the seller.

An even more drastic change resulting from the Proposals would fall upon the shareholder who transferred appreciated assets to his corporation for use in its business. The transfer is tax-free under Section 351, and his basis for the assets carries over to the corporation. The shareholder could sell those assets before transfer and contribute the proceeds, and one tax would apply to the pre-transfer gains. Under current law, if the assets are later sold under Section 337, or are subject to a distribution on liquidation, a single tax, at shareholder level would still apply. However, under the Proposals, the new tax at corporate level on gains, now protected by Section 337, and the tax on corporate liquidations, now generally immunized by Section 336, doubles up the tax which would fall upon the shareholder.

Under current law, there is symmetry for shareholders of closely-held businesses. Neither a sale of stock, sale of assets, nor a liquidation will cause a double tax to apply. Under the Proposals, for such shareholders, the cost of selling or otherwise terminating the business will increase, possibly to a very great extent, depending upon the amount of appreciation accruing in the business over the years.

If the Proposals pass without modification, there would be symmetry once again: such transactions all would be subject to double taxation. The Proposals also would lead to another form of symmetry: shareholders of closely-held businesses would be treated without favorable distinction from the investor or speculator who sells stock and is taxed at capital gains rates (assuming a holding period of anything more than a mere six months). Supposed symmetry is achieved in this case because the investor's or speculator's sale is not an event permitting the corporation to step-up the basis of assets. (Nonetheless, gains on appreciated assets would be deferred and not subject to tax until recognized.)

However, we believe that Congress should make a distinction between the owner of a closely-held business and the investor or speculator in the stock of a closely-held company. The owner of the closely-held business who is the subject of our concern is the risk-taker, the life-long stimulator of local business, the job producer, and, in essence, the backbone of the American Economy. The taxes applicable to his termination of business may fall upon gains accruing over several decades. We do not believe that his situation should be correlated in Congressmen's minds and under the Internal Revenue Code with the investor or speculator in public securities. We believe that any dichotomy of treatment accorded today is based upon the merits as a matter of tax policy.

The Society believes that the Proposals' effort to mitigate the damage from extinguishing the General Utilities doctrine, as represented in Section 337, etc., is wholly inadequate.

The Proposals purport to provide relief, in a liquidation or liquidating sale, from double taxation of gains on "long-held" capital assets (those held for 5 years), owned by "small" businesses (those with stock valued at up to $1,000,000, with a phase-out of relief if values range from $1,000,000 to $2,000,000). The method chosen (Proposed Section 1060) is to permit shareholders generally to adjust the basis of their stock by the amount of gain subject to tax.

The Society believes that this relief provision is excessively restrictive, and will not adequately reach the fundamental issue that the Proposals impose a new level of taxation upon owners of closely-held businesses.

We recommend a series of alternative approaches to the Committee:

1. Re-consideration of the imposition of double taxation on transactions presently subject to the single level of tax treatment accorded by Sections 337 and 338 and, in the case of liquidations, under Section 336.
2. Expansion of the relief provision which is now limited by the $1,000,000 description of "small" businesses; and expansion of description of the gains which will entitle the shareholder to a basis adjustment, now limited to gains on "long-held" capital assets.

   We believe a study should be made to determine whether "small" businesses entitled to relief should be measured by the number of shareholders; the value of stock (in which case the values should be higher than appears in the Proposals); the public or private nature of the corporation; or otherwise.

3. Protection from double taxation of shareholders who formed corporations by the transfer of appreciated property (at least to the extent of the pre-transfer appreciation).

OTHER AREAS OF THE PROPOSALS

The Society supports many of the principles and specific provisions adopted by the Proposals. In general, we favor elective tax treatments, independence of the tax consequences to corporations and their shareholders, and adoption of a single rule limiting the availability of net operating loss and other carry forwards. Our specific and technical comments appear in the following section.

There is no question that the repeal of General Utilities would simplify the law, would reduce the need for collapsible corporation rules, would remove certain legal inconsistencies, etc.; however, we question whether achieving this legal consistency is worth the price of placing a new obstacle before would-be entrepreneurs and punishing those already in business with a new tax and an immediate and possibly substantial loss in the value of their businesses — the businesses that build the wealth from which jobs are created and from which taxes can be paid.

III. ANALYSIS OF PROVISIONS

PROPOSED "SUBCHAPTER C REVISION ACT OF 1985"

The Subchapter C Revision Act of 1985 may be broken down into three major substantive areas:

A. Provisions affecting transfers of stock or assets in corporate organizations and reorganizations,

B. Provisions affecting limitations on utilization of net operating losses following changes in ownership of the loss corporation, and

C. Provisions affecting recognition of gain on corporate distributions of assets.

PROVISIONS AFFECTING TRANSFERS OF STOCK OR ASSETS IN CORPORATE ORGANIZATIONS AND REORGANIZATIONS

The Proposal would restructure the method by which transfers of assets and stock affect shareholder and corporate recognition of gain or loss and basis. If the Proposal were enacted, the tax results to the corporation and the shareholders would be independent of each other. In the case of corporate transfers in a "Qualified Acquisition" (basically an acquisition within one year), a corporation could elect to revalue assets to fair market value upon payment of a tax on the gain. This provision would expand the elective nature of Section 338, as currently in effect, to all types of asset transfers. Shareholders would be permitted to defer gain on receipt of "Qualified Consideration"; but would recognize gain on receipt of non-qualified consideration.

The Society supports the proposed separation of shareholder and corporate tax consequences. Recent trends, especially in the area of Mutual Savings Bank conversions, have linked corporate and shareholder consequences. Transactions have been held to be taxable at the corporate level based on application of the continuity of interest principle at the shareholders' level (Paulsen v. Commissioner, 716 F.2d 563 (9th Cir. 1983), rev'g. 78 T.C. 291 (1982)). The Society does not believe that corporations should effectively be precluded from structuring a tax-free reorganization.

Under this proposed provision, which we support, the entity would be able to structure a qualified transaction without regard to shareholder consequences.

Elective Tax Treatment of Qualified Acquisitions

The Society supports the expansion of elective cost basis treatment. Corporations would no longer be forced to resort to legal gymnastics to secure either a carryover basis or cost basis acquisition.

Corporations would be given a clear choice and clear methods for securing a carryover basis or cost basis results.

Shareholder Treatment

Proposed Section 354 expands the types of transactions in which 354 will apply and focuses on the nature of the consideration (qualified and non-qualified) in the determination of gain recognition. The Proposal (354(b)) specifically permits "Creeping Acquisitions" which were permitted under prior "B" reorganizations, but not under "C", "D" or "E" types. This has the laudable effect of placing substance over form in qualifying acquisitions.

Congress may wish to take a new look at certain problems under Section 385. The Proposal does nothing to clarify the definitions of stock and securities. Therefore, prior case law and other pronouncements will continue to control in this area. (Section 385, added by the Tax Reform Act of 1969, prescribed regulations to deal with this problem, but no final regulations under Section 385 have been issued.) Disputes will continue to arise over the distinction between securities (qualified consideration) and non-security debt (boot). Section 356 provides for recognition of gain on receipt of nonqualifying consideration, but Section 354 provides for deferral of gain on receipt of qualifying consideration.

The explicit statutory test of dividend status where nonqualified consideration is received (proposed Section 356(d)(3)) clarifies a contentious area of current law, and is a desirable amendment. Current authorities differ as to capital gain vs. dividend treatment of a shareholder's receipt of boot in a qualifying reorganization. (Rev. Rul. 75-83; Shimberg v. U.S., 577 F.2d 283 (5th Cir. 1978); Wright v. U.S., 482 F.2d 600 (8th Cir. 1973)). In our view, the Proposal correctly reflects the selling shareholder's interest in the continuing entity, which better reflects the economic reality of the transfer.

PROVISIONS AFFECTING NET OPERATING LOSSES

The Society generally supports the proposed Net Operating Loss (NOL) provisions. Under the Proposal, Section 382 limitations are calculated based on return on investment. The rationale for this change in basic philosophy is to try to limit net operating losses (and other benefits) to a reasonable return on investment in an attempt to discourage tax-motivated acquisitions. The anti-abuse rules of proposed Section 382 are well thought-out and are consistent with the general thrust by Congress to reflect economic reality in the tax law; however, there are certain situations in which the proposed NOL rules may unduly harm taxpayers.

Punitive Effect on Certain Taxpayers

To the extent that the Proposal will result in a lower limit on benefits than would result under either the 1954 or 1976 rules, this change may act in a punitive fashion where shareholders of a loss entity are not able to recoup some of their losses through transfers of their company. A purchasing entity may directly assess the perceived value of net operating losses in the negotiation process.

The proposed limitations would apply where capital contributions are made in anticipation of a change in ownership; however, this may act in a punitive fashion to eliminate NOL's where a loss corporation is only kept alive by continued capital contributions. In addition, the focus on pre-ownership change contributions punishes old shareholders who keep their business alive. At the same time, no direct legislative limit is imposed on post-change contributions which are used to generate income to be shielded by NOL carryovers. The technical analysis of the Act suggests that this area may be addressed by regulations.

Adjustment of net operating loss carryovers under proposed Section 382(f)(4)(B) addresses a valid concern that putative interest payments are in fact dividends in a Chapter 11 situation. However, the broad disallowance of "... interest paid or accrued by the old loss corporation during the 3 taxable years..." preceding the year of change does not take into account the possibility that all creditors within that period do not become equitable owners through Chapter 11.

Revising Section 381

In connection with a revision of 382, Congress might want to consider a revision of Section 381. Section 381, enacted in the 1954 Code, was intended to outline with greater certainty the extent to which corporate attributes survive a tax free transfer of assets between corporations, and to replace the more vague judicial doctrines which applied to Pre-1954 Code years. Section 381 lists a number of attributes which survive a qualifying asset transfer, but the list does not exhaust the possibilities. A new Section 381 might be enacted stating that the acquiring entity succeeds to all attributes of the acquired entity with the exception of those specifically subject to Section 382 limitations (such as Net Operating Losses and Investment Credits).

PROVISIONS AFFECTING RECOGNITION OF GAIN ON CORPORATE DISTRIBUTION OF ASSETS

The Society's concerns with the effect of the Proposals on distributions to owners of closely-held businesses are discussed in our "General Comments" on the Proposals. There are some technical concerns which we believe should be addressed.

Receipt of Installment Notes

The Proposals do not address the effect of a corporation receiving installment notes in exchange for its assets. Under current law in a Section 337 liquidation, installment notes retain their character when distributed and no corporate gain is recognized. Under the Proposals, if corporate gain must be recognized on a sale for installment notes, there may be no cash to pay a corporate level tax. Some mechanism may be required to permit the corporate level tax obligation to be transferred to the shareholder and to be payable upon receipt of installment payments.

Section 333

The proposed amendments to Section 333, which simplify the rules permitting limited recognition of gain in certain liquidations, advance the cause of elective, limited recognition while reducing complexity. Except to the degree that additional simplicity might result from total repeal of Section 333, this proposal focuses on a desirable goal with minimal complexity.

IV. APPENDIX

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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President

Robert L. Gray, CPA
Executive Director

Walter M. Primoff, CPA
Director of Tax Policy

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STATEMENT OF ROBERT A. JACOBS, MANAGING DIRECTOR, MILGRIM, THOMAJAN, JACOBS & LEE, NEW YORK, NY

Mr. **Jacobs**. Mr. Chairman, I join in complimenting the staff on its effort. I think that the process that has been gone through here is the right process, and I think that it is a model for dealing with difficult legislation.

On the merits, while the proposals may not be perfect and a lot of us have spent a lot of time criticizing those merits, it seems to me that by and large the staff report gets a solid A and ought to be enacted.

Senator **Chafee**. Are you referring to the general utilities section, too?

Mr. **Jacobs**. I am, indeed. I would prefer that the type of relief that be offered in the general utilities area exonerate long-held capital assets—I would define long-held arbitrarily as 3 years—and I would apply that relief to all corporations rather than to those that are limited to $1 million.

I would further suggest that consideration be given to answering Professor Cohen's problem, by saying that the tax that should be applied should be a tax of 20 percent rather than 28 percent, or the individual capital gains rate rather than the corporate capital gains rate, once those long-held capital assets qualify.

But I think what we are searching for here is the appropriate relief to the general utilities mechanism, so we can come together and reach a consensus on what to do with general utilities, which is a key to the rest of the provisions.

Senator **Chafee**. Mr. O'Connell and others would say it is fine the way it is.

Mr. **Jacobs**. I don't think the present law is fine; I think the present law is a mess. I think Professor Eustice pointed out that the alphabet soup that we go through on a regular basis, the incongruities in results in acquisitions that are outlined in the green book, and the general experience that we have in practice that Mr. Faber alluded to of total uncertainty is not the kind of law that we need; it has been put together as a patchwork over a number of years, and the result that we have is simply unacceptable. The ABA has said so for years; so have most of these other organizations.

Senator **Chafee**. But Mr. Cohen pointed out that—well, here I am into your testimony. You go ahead.

Mr. **Jacobs**. I would enjoy discussing this however long we go. But my testimony is limited to code section 382, and what I would like to talk about are vacations, if that is OK.

I want to talk about tax vacations and tax holidays. Suppose, Senator, that you are an employer, and you grant all of your employees a vacation of 1 month each year. And under your vacation rules, at the end of each year each employee must take her vacation or receive 1 month's pay in lieu of that vacation. Or, if the employee chooses, she can transfer her vacation rights to another employee, who can then either use the vacation or receive 1 month's pay on his pay level.

Now, I ask you, Senator, could you conceive of adopting a vacation program such as the one described, that would permit an employee earning $12,000 a year to convey a $1,000 vacation right to a fellow employee earning $60,000 a year, who promptly turns in that vacation right and receives $5,000 in cash? As improbable as that sounds, that is the Internal Revenue Code's present vacation policy—tax vacation. Corporate taxpayers possessing net operating loss vacation entitlements, to them worth $1,000 or perhaps as little as zero, may transfer those entitlements to other corporate taxpayers who cash them in as deductions on their forms 1120, receiving cash tax savings of $5,000, $50,000, or millions of dollars.

In my prepared testimony I use an example in which a loss corporation, denominated "L," has $100,000 of operating assets and a net operating loss carryover of $1.4 million. A purchaser, "P," purchases all the "L" stock for $150,000. Under existing law, subject to the possible limitations of section 269, or the SRLY rules, both of which can be avoided, "P" may utilize the entire $1.4 million of losses in the year of purchase or as soon thereafter as "L" can produce $1.4 million of taxable income with "P's" assistance. Under the ABA draft, he could utilize up to 2 percent of the $150,000 per month for 60 months, a total of $180,000. Under the green book, "P" could utilize approximately 1 percent of the purchase price per month against "P's" and "L's" earnings until the NOL's were used up. If the full 15-year carryover is available, the total of $240,000 utilization would be available.

Actuarily, the ABA's formula is somewhat more generous than the green book's formula, depending upon whether you believe in an equity rate of return as opposed to an investment bond rate of return. But, in either event, you have a 5-year or a 15-year tax holiday that is available under the rules, the restrictive rules, that are being proposed. It seems to me that 15 years or 5 years, depending upon your assumptions, is quite adequate to establish a neutral playing field for net operating losses to go through their exercise.

Specifically and particularly, that neutrality principle must be applied in the bankruptcy area. And I have spent a great deal of my prepared text, as you probably have labored through, dealing with the problem of title II organizations and insolvencies, showing how under the appropriate application of the neutrality principle we can get a 5-year or a 15-year holiday, but we need not go from $1,000 to $5,000 of vacation benefits. That is a small fix to be done.

I think the time to fix 382 is now. The time to fix the rest of subchapter C is now, as well, and we ought to go about it.

Senator **Chafee**. Well, no equivocation there.

All right, Mr. Tomasulo.

[Mr. Jacobs' written testimony follows:]

STATEMENT OF ROBERT A. JACOBS, MILGRIM THOMAJAN JACOBS AND LEE PROFESSIONAL CORP.

I am Robert A. Jacobs, a member of the New York City and Washington, D.C. law firm of Milgrim Thomajan Jacobs & Lee Professional Corporation. As an adjunct professor of law at the New York University School of Law, I teach a graduate student seminar entitled Advanced Corporate Tax Problems. I am the former chair of the American Bar Association Tax Section Committee on Corporate Stockholder Relationships and the present co-chairman of the New York State Bar Association Tax Section Reorganizations Committee. I appear on behalf of no client and do not represent the views of any organization with which I am affiliated.

During the past three years your staff has worked with other Congressional staffs, academicians, tax practitioners and Treasury officials to shape the proposals you are today considering. The proposals seek to comprehensively address, redress and rationalize the complexities, incongruities, inconsistencies and vagaries of our present scheme of corporate taxation. The proposals, in large measure, are drawn from the recommendations of the leading tax organizations and writings of respected commentators over the past thirty years. They result from thoughtful analysis of divergent views and concerns, representing the very best thought on this important and vital subject.

Corporate tax law is too complex and concerned constituencies too small to muster often the requisite effort to effect comprehensive and thoughtful remedial legislation. The program has been set in motion; the corporate tax provisions are ripe for reform. I urge you to act on these proposals to bring simplicity, certainty and fairness to our corporate tax law.

A good corporate tax law should have sound philsophical underpinnings, be reasonably certain in its application and not be unreasonably complex. Our present corporate tax structure splendidly avoids each of these criteria. You Staff's proposals to amend Subchapter C would greatly improve the tax law; they should be reviewed, improved upon in certain respects, and enacted—promptly.

Given the limitations of time and resources, I shall not address all the issues presented in the Staff Report,[1] but instead will focus my remarks on Code § 382—the tax attribute carryover limitation provisions—with special emphasis on Code § 382's proper application in cases involving bankruptcy proceedings and the acquisition of controlling interests in insolvent thrift institutions.

Net operating loss ("NOL") utilization is a matter of growing political concern. Use of NOLs, together with safe harbor leases, ACRS deductions, investment credits and other tax incentives, have zeroed out the taxable incomes of nearly half of America's profitable corporations in at least one of the last four years.[2] Congress can ill afford to continue the haphazard and improvident application of the NOL rules to corporate America.

THE 1976 ACT

Green Book §§ 382, 382A and 383 fill 21 printed pages. The American Bar Association's proposed revision to Code §§ 382 and 383 [3] runs a little over five single-spaced typewritten pages. Complexity fans have little to fear from either proposal, but overall, the ABA Draft presents the more familiar and least complex choice. Neither provision rivals the 1976 version of Code § 382 (enated by Congress but mercifully rendered ineffective by successive postponements of its effective dates) for complexity or obscurity.[4] As to the 1976 version, Professor Eustice observes:

> The cause of simplification took a heavy beating in the new law, parts of which never may be subject to rational interpretation, let alone intelligible exposition by regulations. While the corporate changes in the new law do not take highest honors in the complexity sweepstakes, there are parts of new section 382 that at least deserve honorable mention for legislative obfuscation. One can readily concede that it is probably far easier to criticize drafting results than to personally perform that thankless task, but few would deny that substantial improvement is possible, even imperative, in this critical area.[5]

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[1] The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff of the Senate Finance Committee, S.Prt. 99-47, 99th Cong., 1st Sess. (1985) (the "Green Book"); the the proposed statute [Green Book at 77-208] is cited as ("BG § ").

[2] Citizens for Tax Justice, "Corporate Taxpayers & Corporate Freeloaders," (August 28, 1985) discussed in BNA DER No. 168 (8/29/85).

[3] ABA Tax Section Committee on Corporate Stockholder Relationships, Legislative Recommendation No. 1985-1 (the "ABA Draft"). The Section of Taxation and the ABA House of Delegates approved a general resolution calling for the limiting of corporate tax attributes after a change in control to be measured by reference to the loss corporation's value prior to the change. The full report and draft statutory language developed by the Corporate Stockholder Relationships Committee was reviewed by the Tax Section's Council; The ABA Draft proposed statutory language is cited as the "ABA Draft §—."

[4] The 1976 amendments have been characterized as introducing "a quantum increase in complexity. . . ." Fleming, "Reflections on Section 382: Searching for a Rationale," 1979 Brigham Young L. Rev. 213, 215 (1979). They present "some unfathomable provisions and great complexities." Lewis, Testimony on behalf of the American Bar Association before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, United States House of Representatives concerning the Tax Treatment of Corporate Net Operating Loss and Other Tax Attribute Carryovers in Acquisitions, May 22 (the "May 22, 1985 Hearing"). "The result was a statute that, however well intentioned, was confusing, complex, and illogical." Faber, "Net Operating Losses in Corporate Reorganizations Revisited in 1979," 38 N.Y.U. Tax Inst. 4-53 (1979).

[5] Eustice, "The Tax Reform Act of 1976: Loss Carryovers and other Corporate Changes," 32 Tax L. Rev. 113, 114 (1977) (footnote omitted).

No responsible commentator seriously advocates permitting the 1976 Act to become operative. With far better answers now at hand, as embodied in the ABA Draft and the Green Book, the old and failing Code § 382 need not be continued another two years. A new Code § 382 can and should be enacted before the January 1, 1986 effective date of the 1976 version of Code § 382.

THE EMERGING CONSENSUS

Over the past three years, collegial effort among the Congressional staff, Treasury officials, tax practitioners and academics has produced consensus on a large number of the issues involved in the treatment of tax attribute carryovers, drawing from a number of careful studies.

The 1958 advisory group.

The 1958 Subchapter C Advisory Group[6] recommended that following a change in control of a loss company, loss carryovers be allowed only to the extent of 50% of the consideration paid by the purchaser for the loss corporation, a rule that would effectively thwart a tax avoidance purchase of a shell loss corporation because the after-tax value of the allowed loss could never equal the purchase price.[7] The Advisory Group proposal also prohibited "stuffing" the loss corporation with cash or investment assets to artificially augment the purchase price and NOL measure.

ALI.

The 1982 American Law Institute study[8] fashioned a "neutrality principle" to serve as the centerpiece of its proposal, permitting NOLs to carryover after a change of controlling ownership only to the extent the old loss company would have generated income sufficient to absorb them. The ALI proposal did not limit the losses themselves, but rather the earnings available for offset against the losses.

NYSBA.

The New York State Bar Association Tax Section recommended a limitation similar to the 1958 Advisory Group's proposal for post-acquisition losses,[9] limiting loss carryovers to 100% of the acquisition price of the loss corporation and spreading the loss utilization over at least five years.

Bacon and Tomasulo.

In 1983, two former Joint Committee Staff members, Richard Bacon and Nicholas Tomasulo, published their proposed revision to Code § 382.[10] Their proposal permitted NOL carryovers in an amount equal to the full acquisition price in both taxable and tax-free acquisitions. The purchase price limitation was triggered by a major control shift within the prescribed time period. The purchase price limitation was reduced by the loss company's cash or liquid assets, by business assets contributed to the company within 2 years of the triggering event and by proceeds of assets sales (other than in the ordinary course of business) within 5 years after the triggering event.

ABA.

In early 1985, the American Bar Association Tax Section completed its Code § 382 study, issuing a legislative recommendation[11] utilizing a single purchase price formulation to effect the neutrality principle. The ABA concluded the purchaser should be able to use the target's NOLs to the same extent (on a present value basis) as the target could use them. Under the ABA Draft, NOLs equal to 2 percent of the purchase price could be used each month for 60 months following a change in control. The ABA Draft provides no special treatment for investment companies, because no profit could be derived from purchasing shell or investment companies for their tax losses. Old and cold (2 year) debt converted into equity by the seller or purchaser would be treated as part of the purchase price measure for NOL utilization. Anti-stuffing rules and built-in gains and losses receive special treatment in the ABA Draft. Finally section 269 is made inapplicable to transactions covered by new Code § 382.

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[6] See Hearings before the House Ways and Means Committee on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code, 86th Cong., 1st Sess. (1959).

[7] Professor Edwin S. Cohen, a member of the Advisory Group, recalls that there was a reason for fixing the limitation at 50% of the consideration, but he could not recall what that reason was. A search of the Advisory Group records in his attic turned up a number of interesting items [many not related to the Advisory Group's work], but no further insights.

[8] American Law Institute, Federal Income Tax Project, Subchapter C (1982).

[9] See Camp, "Carryovers of Net Operating Losses Following Changes in Corporate Ownership," 43 NYU Tax Inst. 3-32 (1984).

[10] 20 Tax Notes, 385 (Sept. 12, 1983).

[11] The ABA Draft, note 3, supra.

The Green Book.

The Senate Finance Committee Staff's Green Book borrows heavily (and generally well) from the earlier studies, embraces the neutrality principle and criticizes current law and the 1976 Act as not focusing on the ability (or inability) of the loss corporation to use its losses while frequently permitting purely tax motivated transactions to be effected. The Green Book also properly criticizes existing law as——

1. Giving too much weight to the continuity of business rules;
2. Providing an all or nothing cliff effect, in many cases unjustly preserving in tact or completely forfeiting NOLs;
3. Placing to much reliance on the 20 percent continuity of shareholder interest in reorganization transactions;
4. Failing to recognize the effect of built-in gains and losses on the operation of Code §§ 382 and 383; and
5. Being inconsistent, complex, uncertain and incomplete.

The Green Book proposes a single neutrality principled rule that would limit tax attribute carryover utilization to an assumed amount each year following a prescribed change in corporate ownership. That utilization rate is fixed as the product of the value of the loss corporation at the time of ownership change times the Federal long-term rate prescribed by Code § 1274(d). The Green Book provides a rigorous anti-stuffing rule to prevent an artificial augmentation of the purchase price; provides no carryovers for "investment companies" and provides for built-in gains and losses. Special considerations are granted insolvent corporations and corporations involved in title 11 proceedings. Code § 269 and Libson Shops would not apply to transactions covered by GB §§ 382, 382A and 383.

Where From Here.

The various proposals are discussed in varying detail below.[12] The differences among these proposals and the Green Book formulation, are not critical. They build upon one another and reach similar results in most cases. While knowledgeable people may differ as to which proposal is best, most agree that almost any is to be preferred over existing law. The best of what is before Congress should be enacted promptly.

Code § 382 should be amended to provide a single exclusive limitation for tax attribute carryovers following a change in control of the target corporation possessing those tax attributes. Utilization of those corporate tax attributes should be limited to a percentage of the target corporation's value before the change in control—a value generally measured by the purchase price of the target loss corporation.

Code § 382, as currently in effect (i.e., without giving effect to the 1976 amendments), does not effectively or fairly police perceived problems of trafficking in loss carryovers and other corporate tax attributes. The other principal statutory provision applicable in these transactions, Code § 269, is ineffective, unfairly penalized some transactions and leaving unaffected other transactions that should be subject to tax attribute reductions. In practice, these provisions combine to produce uncertainty and unfairness, not infrequently at the cost of the seller and the Treasury and to the benefit of purchasers of loss companies.

The best resolution of the tax attribute carryover problem is to embrace the "neutrality" principle formulated by the American Law Institute in its 1982 report as that principle is embodied in the ABA Draft. The key to applying the neutrality principle is approximating and preserving the value of the tax attributes as they exist in the hands of the seller—without enhancement or diminution—in the hands of the buyer. Under a neutrality principle based statute, tax attributes may be negotiated for a price—provided the tax attributes are incident to an acquisition of income-producing assets, i.e., part of a corporate acquisition. Adopting the neutrality principle would not foster the trafficking in loss carryovers, but would enable a loss corporation to transfer freely its beneficial tax attributes incident to an overall change in its control. Properly structured and applied, a statute based on the neutrality principle would provide sellers with fair compensation for the tax attributes transferred by them to buyers, prevent buyers from obtaining tax attribute windfalls and leave the Treasury neither enhanced nor diminished by tax attribute transfers.

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[12] For a comprehensive review of the development of the various proposals, see Camp, "Carryovers of Net Operating Losses Following Changes in Corporate Ownership," 43 N.Y.U. Tax Inst. 3-28 to 3-37 (1984).

The ABA Draft grosses up the purchase price to 120% of the amount paid and spreads the NOL utilization over 60 months following a change in corporate control, an intelligent application of the neutrality principle, properly balancing the theoretical application of the principle with business realities. The 60-month utilization period answers the need to not favor unduly large potential acquirors over smaller ones while maintaining a realistic view of the time span over which businesses expect to utilize purchased tax attributes.

LIMITING NOLS VS. LIMITING INCOME UTILIZATION

The Green Book (and ALI) limit the post-change taxable income of the loss corporation that may be offset by NOL carryovers, instead of "cutting down" the useable NOLs, as does present law and the ABA Draft. This change is heralded by some as a significant improvement. In truth, these distinctions are largely semantic, particularly in the context of the ABA Draft that (i) limits the loss carry-overs; and (ii) spreads their utilization over 60 months at a rate of 24 percent per year, a rate that yields a present value approximately a 15-year utilization at a slower rate. Using familiar terminology and structure, the ABA Draft achieves the same neutrality result as the Green Book, i.e., the value of the NOL in the hands of the buyer will approximate its value in the hands of the seller.

Bowing to real life valuations, the ABA Draft opts for a faster NOL utilization rate (24% of purchase price per year) and a shortened utilization period (60 months) than the Green Book's lower rated (the Federal long-term interest rate purchase price each year), longer utilization period (up to 15 years). Depending upon assumed earning projections, interest and discount rates, the two formulae can achieve the same, similar or disparate present values. But, there is no fundamental difference between them. Generally, the ABA formula will be more favorable to taxpayers because it uses an assumed equity pre-tax return of approximately 20% in fixing its NOL annual allowance while the Green Book uses a debt pre-tax return of 12% or so. The ABA formula is the more practical and realistic solution.

The one apparent significant difference between the ABA Draft and the Green Book found in EG(2) at Green Book 246 is not a difference, but a mistake:

EG(2): On January 1, 1986, all of the stock of corporation L, a calendar year taxpayer, is sold in a transaction constituting an ownership change of L. On that date, L has $500,000 of unused net operating loss carryforwards from 1985. Assume that the section 382 limitation is $150,000 per year. Further, assume that L has no built-in gains or losses, and that L has a loss of $300,000 in 1986 and taxable income (before application of any net operating loss deduction) of $200,000 in 1987.

In this example, the 1985 loss is used first to reduce L's taxable income in 1987. However, the section 382 limitation only permits the loss to be used to offset $150,000 of 1987 taxable income. The remainder of the 1985 loss is carried forward for use subsequent to 1987. The remaining $50,000 of taxable income in 1987 may be offset by the 1986 loss. As a result, after application of the net operating loss deductions, L has no taxable income in 1987 and has $350,000 of net operating loss carryovers from 1985 and $250,000 of carryovers from 1986.

The ABA Draft would permit L, in 1987, to utilize NOLs of up to 48% of the L value on the date the L stock was purchased. The 24% of purchase price that was not used in 1986 carries over to 1987.[13] GB § 382(2)(A) would appear to require a similar result, *i.e.*, the $150,000 section 382 limitation not used in 1986 should have increased the 1987 section 382 limitation to $300,000. If so, the Green Book's conclusion in EG(2) is wrong; $200,000 of L's 1985 loss is used to eliminate L's taxable income in 1987. In 1988 L has $300,000 of net operating loss carryovers from 1985 ($250,000 of which may be used in 1988) and $300,000 of carryovers from 1986.

If this analysis is correct, the only significant economic difference between the ABA Draft and the Green Book as they define and limit NOL utilization is the rate at which the L losses may be utilized after a change in control. The ABA Draft would permit 24% per year for 5 years; the Green Book AFR (presently 11%) for up to 15 years. That difference could be reconciled by changing those rates; *i.e.*, lowering the ABA Draft rate or increasing the Green Book rate. There is no fundamental differences in principle. But, the impact of corporate taxpayers can be substantial. The key issue is how prospective purchasers and sellers view L's changes of economic recovery.

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[13] ABA Draft § 382(b).

BUILT-INS

GB § 382(e) deals effectively, if not altogether succinctly, with built-in losses and gains, i.e., losses and gains accrued but not recognized. Had the built-in loss been recognized by the loss corporation before the change in control, the loss would have been subject to the post-change limitations on NOL carryovers. The Green Book proposal subjects built-in losses to the same limitations applicable to recognized losses that have become NOLs.[14] Had a built-in gain been recognized by the loss corporation before the change, the gain would not have been taxed. It would have been offset by the loss corporation's losses and loss carryovers—without limitation. Recognizing these principles, the Green Book permits pre-change losses—without limitation—to offset built-in gains as and when those gains are recognized.[15] Because built-in gains increase the limitation only when the gains are actually recognized (during the 5-year recognition period),[16] their mere existence, without recognition, does not increase the GB § 382 loss availability.

While the ABA Draft uses only six lines of text for its built-in gain and loss provisions,[17] GB § 382(e) requires 65 lines. While the Green Book deals with more aspects of the built-in problem, one may question whether the additional statutory volume and complexity is worth the limited additional benefits derived.

GB § 382(e)(5) defines "recognition period" as the first post-change year [18] and the four succeeding post-change years. During the recognition period, all gains on the disposition of assets are treated as other than built-in gains, unless the taxpayer establishes that the gain is allocable to a pre-change year. All losses on the disposition of assets are treated as built-in losses, unless the taxpayer establishes that the loss is allocable to a post-change year.

So far, so good. Here at least is certainty—to a point. The burden of proof is placed on the taxpayer; the time frames are fixed and the items covered are clear—all assets. But then GB § 382(e)(4)(C) delegates to the Treasury Secretary the power to promulgate regulations treating other deductions as built-in losses [but not gains], e.g., deductions deferred under Code § 267 or built-in depreciation deductions.[19]

Mercifully, GB § 382(e)(4)(B) provides a threshold requirement for the special treatment of built-in gains or built-in losses. If the built-in gain or built-in loss does not exceed 25 percent of the fair market value of the loss corporation's assets [20] before the change, the built-in gain or loss is deemed zero. This threshold provision—which should eliminate a substantial number, if not substantially all potential built-in disputes—is apparently derived from the Consolidated Return Regulations.[21] Where the built-in loss rules will apply, or where the threshold amount is uncertain, an appraisal will be required. That appraisal expense may not be timely or cost justified in the case of many corporations trying desperately to turn around their economic fortunes. If no profits eventuate, the appraisal is of no value. And, even if the loss corporation becomes profitable, the extent of the built-ins may not be of any tax significance.

OWNERSHIP CHANGES

GB § 382A(a) defines an ownership change as a "more than 50-percent owner shift, or a more than 50-percent equity structure change. . . ." There is more than a 50-percent owner shift if the aggregate value of L stock held by L's 5 percent (or greater) shareholders has increased or decreased by more than 50 percentage points over a 3-year testing period.[22] Under this test, presumably cases presenting Maxwell Hardware[23] facts, where P purchases a special class of L participating preferred stock, worth less than 50 percent of the L outstanding stock would not be affected by GB § 382, because there would be less than a 50 percentage point change. By contrast, the ABA Draft, by focusing on changes in "participating stock," i.e., stock with a proportionate participation in growth not substantially below its proportionate net worth, would block future Maxwell Hardware NOL loan-out arrangements.

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[14] GB § 382(e) at Green Book 190.

[15] GB § 382(b)(1)(B) at Green Book 187.

[16] GB § 382(e)(5) defines "recognition period" as the first post-year change and the four succeeding post-change years. . . ." Green Book at 192.

[17] ABA Draft §§ 382*e(, 382(b)(2), 382(a)(6).

[18] GB § 382(c)(2) defines "post-change year" as any taxable year ending after the change in control. Green Book at 190.

[19] Green Book at 247.

[20] Cash, cash items and Government securities with a maturity (at issue) of less than 3 years are excluded from the asset count. GB § 382(e)(4)(A)(ii) at Green Book 191–92. If this provision is intended to block a temporary stuffing of assets into the loss company to avoid the 25 percent threshold, it misses the mark. Government securities (long-term at issue) with near maturity dates or traded stocks combined with put options or subject to deep in-the-money calls effectively accomplish the same stuffing result as cash or cash items. Either the test should be dropped or buttressed by a subtraction for net worth contributed within a prescribed period before the change in control. Cf. Code § 341(e)(7)(B) excluding from net worth assets contributed (or exchanged in Code § 351 transactions) if the transfers do not have a bona fide business purpose.

[21] See Treas. Reg. § 1.1502-15(a)(4)(i)(b).

[22] Green Book at 250–51.

The Green Book's change in ownership rules apply even where there is no concerted plan to effect a change. The 3-year testing period of GB § 382A(e) would trigger the GB § 382 NOL limitations where P_1 purchases 45% of L from A and 2½ years later P_2 (unrelated to P_1) purchases a 7% L interest from B (unrelated to either A or P_1) in an unrelated transaction. The uncertainty of future ownership shifts and their adverse effect on L's NOLs will permit P_1 to argue that L's NOLs may not carry forward and thus argue for and receive from A a reduced purchase price, exacting a tax windfall. This perpetuation of the existing state of NOL transfers is not warranted or desirable.

GB § 382A(d)[24] exempts specified transfers from the change in control rules. These exceptions apply to transfers among related parties specified in Code § 318, stock acquired by gift, death, divorce or separation—salutary rules all.

INVESTMENT COMPANIES

GB § 382(f)(3)[25] contains an unfortunate provision disallowing all carryovers in the case of an investment company, defined as a corporation at least two-thirds of the assets of which consists of investment assets.[26] Some commentators argue that the perception of people purchasing shell corporations without ongoing business operations and utilizing their NOLs is simply unacceptable.[27] They argue that where, as is contemplated by the Green Book, Code § 269 would no longer apply to acquisitions covered by GB § 382, the blessing of loss carryovers where there has been both (i) a change in corporate ownership and (ii) a termination of the former business conducted by the loss company, is more than the statute can or should bear.[28]

In large measure, the adoption of the neutrality principle, permitting loss carryovers to be absorbed only to the extent income of the loss company reasonably could be expected to have been generated from its pre-change income earning assets, removes much of the pressure from Code § 382. Under GB § 382, where a change of control has been effected, the buyer cannot gain "windfall" NOL utilization. The present value of a right to tax savings derived from deducting 12% of the purchase price each year for 15 years (or 24% for 5 years) is substantially less than that purchase price. There will be no trafficking in shell NOL companies under either the Green Book or ABA Draft formulations. The Green Book investment company departure from the neutrality principled statute is not needed to protect the Treasury from the perceived abuse.

An investment company limitation is inconsistent with the "neutrality principle" that serves as the cornerstone of the ABA Draft. Under the ABA Draft and the Green Book, corporate tax attribute utilization following a change in control is generally limited to an amount bearing a targeted relationship to the value of those attributes in the hands of the loss corporation had there been no change in control. That goal is not achieved if tax attribute utilization is denied corporations whose investment assets exceed the permitted two-thirds limit. To deny tax attribute utilization to investment companies frequently would render the value of the attributes to the purchaser significantly less than their value to the seller—a rule that would impede economically desirable purchases and sales of corporate businesses.

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[23] *Maxwell Hardware* v. *Commissioners*, 343 F.2d 713 (9th Cir. 1965).

[24] Green Book at 200.

[25] Green Book at 195–96.

[26] Mutual Funds and real estate investment trusts are not investment companies. GB § 382(f)(3)(B) at Green Book 195. 50% owned [vote or value] subsidiaries are not deemed business assets, but instead the parent's ratable share of the subsidiary's assets will be deemed owned by the parent. GB § 382(f)(3)(C) at Green Book 195–96.

[27] Statement of Nicholas Tomasulo, May 22 Hearing. See also, Camp, "Carryovers of Net Operating Losses Following Changes in Corporate Ownership, N.Y.U." 43d Tax Inst. 3–26 (1984):

"Cosmetic concerns also seem to motivate some of Congress's distaste for free traffic in loss carryovers. Permitting the unrestricted purchase of loss corporations might seem improper to the general public. The controversy over safe-harbor leasing indicates that free purchase of loss corporations might make the tax system appear unfair, regardless of its objective merits. Because it is important that the public perceive the tax system as equitable, the appearance of impropriety in free transfers of losses might justify restrictions even absent actual harm." (Footnotes omitted.)

[28] In Alprosa Watch Corp., 11 T.C. 240 (1948), the Tax Court approved a loss carryover where the glove business was terminated, all the stock of the shell sold and a profitable watch business inserted to use the NOLs. Congress, in 1954, sought to reverse that decision in post-1954 cases. See S. Rep. No. 1622, 83d Cong., 2d Sess. 53, 284–85 (1954).

At the May 22 Hearings, ABA Tax Section Chairman Lewis posited the following example: Consider a corporation that has a net operating loss carryover of $10,000 and owns $20,000 of Treasury bonds, yielding 10% per year. To its present owners, that corporation is worth somewhat more than $20,000, because, by virtue of its loss carryovers, the corporation will pay no income tax on the $2,000 of interest it earns each year for the next five years. Were the tax law to deny a purchaser who pays $23,000 or more for the stock of the corporation the economic benefits of using those attributes, that law would effectively prevent the sale of the corporation. No knowledgeable purchaser would pay more than $20,000 for the corporation and no knowledgeable seller would accept only $20,000.

Suppose that the corporation also operates a small business worth $5,000 that produces a profit of $1,000 per year, susceptible to improved profit performance with the infusion of better management. Sound economic and tax policy should encourage the transfer of the corporation to a purchaser at a price of $28,000 who could more effectively manage it and increase its productivity. In the hands of the seller, the corporation could earn $3,000 a year without paying tax. In the hands of the buyer, under GB § 382(f)(3)(A), no carryover utilization would be permitted and a full tax would be exacted on L's $3,000 of income each year. The disparity between the ability of sellers and buyers to utilize tax attribute carryovers would make it practically impossible for the parties to agree on a fair purchase price.

From a practical standpoint, the Green Book's termination of carryovers where the old loss corporation is an investment company would introduce unwarranted complexity and uncertainty into the bargaining and tax administration processes. No acceptable definition of investment assets is readily available. Assets such as working capital held in the form of cash or temporary investments (*e.g.*, Treasury bills); real property held for rental under a net lease; stocks, options, commodities, or futures contracts held in an actively managed portfolio, including hedging transactions; or property of any kind subject to an executory contract of sale or a put or call option may be "investments" or working assets. How shall they be classified?

At the May 22 hearing, the Treasury Department and the New York State Bar Association joined the ABA in urging the adoption of a neutrality rule without regard to the composition of the loss company's assets. On philosophical and practical grounds, an active business rule in any form is not necessary. Congress can explain how the neutrality rule works—buyers pay for and get that which the sellers would have gotten. No sense of unfairness should materialize. Removing the investment company exception to the normal neutrality principled loss carryover rules will shorten the statute, avoid controversy and permit the neutrality principle to function properly.

DEBT IS DEBT

In fixing the amount of post-change in control income that may be offset by prechange NOLs, the Green Book multiplies the applicable Federal long-term rate ("AFR") by the purchase price of the loss company's stock. Purchased debt does not enter into that computation. That rule can be unfair.

Example: In 1986, A organizes L corporation to develop a promising new software computer program she invents. A capitalizes L with $100,000 of common stock and $300,000 of securities, her entire life savings. L spends and properly expenses $400,000 as research and experimental expenses under Code § 174. L is not an S corporation. Development costs exceed projections; another $500,000 will be required to complete the development. In 1989, P purchases all the L stock and the L debt from A for $500,000, $300,000 allocable to the L debt and $200,000 to the L stock. P immediately contributes the L debt to L's capital.

Under the Green Book formulation, even though P pays $500,000 for L, and even though after the contribution of debt to L's capital, that entire payment is embodied in L's common stock, L would be able to utilize only $200,000 as a base, against which the AFR is to be multiplied to establish the annual permitted NOL utilization. That result is wrong.

The Green Book would not permit A to ameliorate these results by contributing the $300,000 debt to L prior to the sale of her L stock to P for $500,000, rather $200,000, because the contribution to L's capital, within two years of the change in control, would be eliminated from the purchase price used to compute the GB § 382 limitation under the Green Book anti-stuffing rule.[29]

The justification for limiting L's annual post-change loss utilization to $200,000 times the AFR boils down to "debt is debt." In effect, the Green Book argues that because A chose to capitalize L with stock and debt, rather than stock alone, A is properly stuck with that election. As long as the debt remained unconverted, L was entitled to claim interest deductions for interest paid or accrued. No look back is warranted say the Green Book authors.

These arguments tend to overlook two principal features of the described transaction. First, the directly affected taxpayer is P, and A. From P's perspective, the acquisition cost is $500,000 and is embodied solely in the L common stock. Had L been capitalized solely with common stock from the beginning, the economics to P would have been the same,[30] yet if the debt had been equity all along, the available annual tax utilization of the NOL (assuming a 12% AFR) would be increased from $24,000 per year to $60,000 per year.

The ABA Draft ameliorates these harsh results.[31] Contributions that increase L's acquisition value are permitted to replace L's ordinary course of business losses during the two years preceding the change in control. Additional contributions are permitted to fund ordinary course of business needs where the contributions were not made to augment the purchase price. More directly, the ABA Draft contains an explicit provision, permitting P to purchase old and cold (two years or older) L debt from A (or from any other creditor) and then, pursuant to the acquisition plan, contribute that debt to the loss corporation.[32] This amelioratory rule only applies to the conversion of "old and cold" debt, i.e., debt created from the transfer of assets to the target corporation more than two years preceding the change in control. Moreover, the amount that can be treated as "acquisition value" must be converted into stock of the target corporation "in connection with the change in control," in which case the amount of P's acquisition value will be increased by the lesser of the fair market value of the converted debt or its tax basis.

The unfairness generated by treating all debt as debt and all debt conversions as being subject to the anti-stuffing rules of Code § 382 is not justified by the modest simplification those rules achieve. If previously claimed interest deductions on the converted debt are a concern, a provision similar to GB § 382(f)(4)(B) reducing the NOL by the interest deductions claimed on the converted debt within three taxable years preceding the change in control would address that concern directly. Taxpayers should not qualify for or be denied NOL utilization by reason of the type of L capitalization P purchases. If P is willing to convert its purchase into an equity purchase only and the converted debt is old and cold, treating the lower of the purchase price or basis as a measure of NOL utilization seems both fair and appropriate.

BANKRUPTCY CONSIDERATIONS

L, a loss corporation, has operating assets of $100,000; liabilities of $1,000,000; and an original investment by its stockholders of $500,000. Its tax balance sheet looks like this:

L balance sheet

Operating assets	$100,000
Liabilities	1,000,000
Capital stock	500,000
Accumulated deficit (NOL's)	(1,400,000)
Total	100,000

L is hopelessly insolvent—its liabilities greatly exceed its assets. L seeks help under "title 11"—the Bankruptcy Code (11 U.S.C.A.):

I. Old L creditors exchange stock for debt: In the title 11 proceeding, L reorganizes; its former shareholders cease to own any L stock; and L's old and cold creditors exchange their notes and accounts receivable for L stock.

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[29] GB § 382(f)(2)(B) at Green Book 195.

[30] The textual statement assumes no interest deductions contributed to L's NOL. As discussed below, appropriate adjustments may be made for interest deducted on debt contributed (or converted) to L to the extent the interest deductions increased L's NOL. See GB § 382(f)(4)(B) at Green Book 197.

[31] ABA Draft § 382(d).

[32] Id.

L's tax balance sheet, now much improved looks like this:

L balance sheet

Operating assets	$100,000
Liabilities	
Capital stock	1,500,000
Accumulated deficit (NOL's)	(1,400,000)
Total	100,000

Tax treatment of L

By converting its creditors into stockholders, L has regained solvency. That process—involving the cancellation of $1,000,000 of L indebtedness—presents the question of whether that debt cancellation is "discharge of indebtedness" or "cancellation of indebtedness" income, the subject matter of Code § 108, as revised by the Bankruptcy Tax Act of 1980, P.L. 96-589. If the debt reduction constitutes cancellation of indebtedness income described in Code § 108(a), then L, as the debtor in a title 11 case, (i) will not recognize any income from the debt cancellation,[33] but (ii) will be required to reduce its NOL carryovers one dollar for each dollar of cancellation of indebtedness income excluded under Code § 108(a).[34] On the other hand, if the cancelled debt is not excluded from L's income under Code § 108(a), but is instead excluded from L's income because of the stock-for-debt exception to the cancellation of indebtedness rule established by the pre-1980 case law and recognized in Code §§ 108(e)(8) and 108(e)(10), there would be no exclusion under Code § 108(a)(1) and no NOL reduction under Code § 108(b).[35]

Perhaps we should pause and review what has just been said. Code § 61(a)(12) states the general rule, derived from Kirby Lumber,[36] that gross income includes cancellation of indebtedness income. Code § 108(e)(10) recognizes the continuing viability of the judicially developed stock-for-debt exception to the Kirby Lumber rule, where an insolvent debtor or debtor in a title 11 proceeding issues its stock to retire its debt.[37] If the stock-for-debt exception applies, the insolvent or bankrupt debtor

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[33] Code § 108(a)(1)(A). For an excellent pre-1980 discussion of the discharge of indebteness rule and its exceptions, see Eustice, "Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion," 14 Tax L. Rev. 225 (1959) (the state of the law governing bargain debt discharges is at best complex and at worst nearly inscrutable). Comprehensive updates are found in Asofsky, "Discharge of Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980," 27 St. Louis U.L.J. 583 (1983) ["Asofsky/St. Louis"] and Eustice, "Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposals—Corporate Aspects," 36 Tax L. Rev. 1, 5 (1980) ("Few could argue that the existing system for the taxation of debt cancellation transactions was beyond improvement. . . .").

[34] Code § 108(b).

[35] See Asofsky & Tatlock, "Bankruptcy Tax Act radically alters treatment of bankruptcy and discharging debts," 54 J. Taxation 106, 108–09 (1981). The House version of the Bankruptcy Tax Act of 1980 would have greatly narrowed the stock-for-debt exemption to the cancellation of indebtedness income rule. The Senate deleted the House changes, retaining the general rule of prior case law that gains from the satisfaction of debt with stock of the debtor are protected by Code § 1032. In 1984, Congress enacted Code § 108(e)(10)(A), generally terminating the stock-for-debt exception of prior case law as applied to debtor corporations other than those involved in title 11 cases or those debtor corporations that are insolvent.

[36] *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931).

[37] The common law cases and ruling that developed the stock-for-debt exception to the *Kirby Lumber* rule were *Commissioner* v. *Capento Securities Corp.*, 140 F.2d 382 (1st Cir. 1944) and *Commissioner* v. *Motor Mart Trust*, 156 F.2d 122 (1st Cir. 1946), *acq.*, 1947-1 C.B. 3 and Rev. Rul. 59-222, 1959-1 C.B. 80. See Berger, Note—Debt-Equity Swaps, 37 Tax Lawyer 677, 680–92 (1984). "The stated rationale behind these cases and the revenue ruling is that the replacement of debt with stock merely represents a continuation of the existing liability in a different form and hence is not a taxable event. The acquired debt is not considered discharged; rather it is 'transformed from a fixed indebtedness to a capital stock liability.'" Berger, supra at 684 citing Tower Bldg. Corp., 6 T.C. 125 (1946), *acq.* 1947-1 C.B. 4 and Alcazer Hotel, 1 T.C. 872, 879 (1943), *acq.* 1947-1 C.B. 1. "[T]he exception was applied notwithstanding the fact that the stock may be substantially different than the debt obligation, or that the value of the stock issued was substantially less than the debt cancelled." General Explanation of the Deficit Reduction Act of 1984 at 167 (the "1984 Blue Book"). The stock-for-debt exception, resulting in (i) no income to the debtor corporation and (ii) no reduction in the debtor corporation's tax attributes, is available only to insolvent debtors and debtors in title 11 proceedings. Moreover, the exception is unavailable where only nominal or token shares are issued in exchange for the cancelled debt [Code § 108(e)(8)(A)] or with respect to any unsecured creditor, where the ratio of the value of the stock

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(i) realize no cancellation of indebtedness income under Code § 61(a)(12); (ii) has no cancellation of indebtedness income excluded under Code § 108(a)(1); and (iii) reduces none of its favorable tax attributes under Code § 108(b)—a most favorable result.[38] Prior to 1984, the judicially developed stock-for-debt rule applied both inside and outside bankruptcy.[39] After the enactment of Code § 108(e)(10), in 1984, the stock-for-debt exception to the cancellation of indebtedness income rule is generally limited to insolvent debtors and debtors in title 11 proceedings.

Where L issues both stock and other property to its creditors in exchange for L debt, an allocation must be made to determine how much debt is retired for how much stock (tax free) and how much debt is retired for other property (taxable). The Senate Finance Committee Report accompanying the Bankruptcy Tax Act provides.

"If a corporate debtor issues a package of stock and other property in cancellation of debt, the cash and other property are to be treated as satisfying an amount of debt equal to the amount of cash and the value of other property, and the stock is to be treated as satisfying the remainder of the debt."[40]

If, in a title 11 proceeding, all L creditors exchange all their L debt solely for L stock, L will recognize no cancellation of indebtedness income under Code § 108(a) and will suffer no loss of its favorable tax attribute carryovers under Code § 108(b).[41]

Present Code § 382

Under present law, L will have to confront Code § 382(a), providing, in effect, that if L's creditors "purchase" a controlling interest in L, and L does not continue conducting a trade or business substantially the same as that conducted by it before the change in ownership of the L stock, L's NOL carryovers will be terminated. Even if L successfully invokes the stock-for-debt exception to Code § 108 income nonrecognition and tax attribute (NOL) reduction, the Code § 382 change of stock ownership threshold will have been crossed,[42] leaving the continuing business test as the sole determinant of NOL viability.

The ABA draft approach

Under the ABA Draft, as under present law, if in a bankruptcy reorganization L's creditors exchange their L debt for L stock, L's NOLs would be unaffected. The ABA Draft drops the continuing business test. Although L would have had a 50% "change" in control, its NOLs would remain intact because of the stock-for-debt exception written into the ABA Draft:[43]

> In applying paragraph (1) [defining "change in control"], the following transactions shall be disregarded:
>
> Acquisitions of stock by a creditor of a corporation in exchange for a creditor claim against the corporation, buy only if the claim was not created or acquired principally for the purpose of obtaining the stock, and only if the stock is received (i) in a title 11 or similar case (within the meaining of section 368(a)(3)(A)); (ii) where (but only to the extent) the debtor corporation is insolvent; or (iii) where at least 50 percent of the total indebtedness of the corporation is extinguished pursuant to the exchange plan . . .

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received by that unsecured creditor to the amount of his indebtedness cancelled or exchanged for stock of the debtor is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout. Code § 108(e)(8)(B).

[38] The Senate Finance Committee Report reveals Congress' determination to continue to apply the common law developed stock-for-debt exception to the Kirby Lumber rule. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 17 (1980). "The Committee bill generally does not change the present law developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt." Code § 108(e)(10) limits those principles to insolvent debtors and debtors in title 11 proceedings after July 17, 1984.

[39] *Commissioner* v. *Motor Mart Trust*, 156 F.2d 122 (1st Cir. 1946), *acq.* 1947-1 C.B. 3; Capento Securities Corp., 47 B.T.A. 691 (1942), aff'd, 140 F.2d 382 (1st Cir. 1944).

[40] S. Rep. No. 96-1035, 96th Cong., 2d Sess. 17 (1980).

[41] The textual discussion assumes the exchange will be treated as a stock-for-debt exchange and not a contribution to L's capital, a concern discussed below.

[42] Prior to the Bankruptcy Tax Act, the stock-for-debt exchange could have been structured as a Code § 351 exchange to avoid the "purchase" of a controlling interest under Code § 382(a).

[43] ABA Draft § 382(c)(2)(C).

This Draft provision bows to the perception that public policy (or practical politics) demands generous treatment for insolvent companies.[44] Under the ABA Draft, if in the title 11 proceedings the L creditor interests are sold to new investors who do not purchase their L debt for the purpose of effecting an exchange of the L debt for L stock, but who subsequently participate in a stock-for-debt exchange with L, presumably L's NOLs would continue undiminished. But, if the order is reversed, i.e., the L debt is first exchanged by its historic holders for L stock and the L stock is subsequently sold to a new purchaser, the NOLs would be reduced to 120% of the purchase price paid for the stock. This is a large and unfortunate distinction arising from a formalistic difference.

The Green Book approach

The Green Book Draft provides special rules applying Code § 382 in "a title 11 or similar case."[45] As in the ABA Draft, the Green Book proposes triggering no change in NOL utilzation because of a change in control if L's shareholders and creditors immediately before the change own (immediately after the change) 50% of the [vote and value] of the stock of the new loss corporation. Thus, in the garden variety title 11 stock-for-debt exchange case (where L's creditors exchange their debt for L stock), L would not lose any of its NOL carryovers. Moreover, under the Green Book, there would be no continuing business test hurdle. While the Green Book drops the continuing business test, as such, it adds a provision denying loss carryovers to investment companies, i.e., a corporation whose business assets constitute less than one-third of the total value of the corporation's assets.[46] Because the GB § 382(f)(4) title 11 exception does not triggers a change of control, the GB § 382(f)(3) rules, providing for a loss of NOL carryovers if immediately before a change in control the loss company is an investment company, will not reduce the loss company's NOLs, where the company participates in a title 11 or similar case.

The Green Book provides the inevitable, albeit minor, exception to the no NOL reduction in title 11 stock-for-debt cases. Where L has escaped NOL reduction by virtue of the GB § 382(f)(4)(A) exception for title 11 stock-for-debt exchanges, L's NOLs will be reduced by any interest deduction allowed L during the three taxable years preceding the change attributable to debt converted into stock in the title 11 proceeding.[47] The rule is fashioned "on the notion that the creditor's interest prior to the change was, in reality, an equity interest and, therefore, payments made to the holder of the interest should not be deductible by the corporation."[48] This effort to achieve fairness may involve more complexity than it is worth. Yet, for corporations that undergo a title 11 stock-for-debt reorganization, reducing the NOL to reflect interest paid on the converted debt seems reasonable.

GB § 382(f)(4)(C) adds a second special rule for title 11 situations. If within two years of a change in control effected under title 11, another change in control occurs, "the section 382 limitation with respect to such second change shall be zero."

This rule simply confirms that because the value of the loss corporation at the time of the first change was presumably zero, and any capital contributions during the two years prior to the second change are generally disregarded. The value of the corporation at the time of the second change is still zero. Thus, no net operating loss carryovers would survive the second change of ownership.[49]

This result may be unduly harsh, particularly in turnaround cases where the price paid for the stock in the second change of control is attributable to the loss corporation's earnings subsequent to the first change in control and its future earnings prospects and not to capital contributions "stuffed" into the corporation during the two-year measuring period.

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[44] "The promulgation of attribute reduction rules produced a firestorm of criticism from creditor interests and the bankruptcy bar at hearings on the Bankruptcy Tax Act." Asofsky, "Reorganizing Insolvent Corporations," 41 NYU Tax Inst. 5-50 (1982) ["Asofsky/ NYU"]. Asofsky also notes that—"Creditor interests and the bankruptcy bar feel strongly that the tax laws should be structured to rehabilitate debtors through exclusion of income from the discharge of indebtedness without any corresponding reduction in tax attributes. They also urge the enactment of liberal rules for carryover of these attributes through bankruptcy reorganizations, even where the ownership of the debtor changes hands." Id. at 5-41. See also Bryan, "Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps," 63 Texas L. Rev. 89, 101-107.

[45] GB § 382(f)(4). GB § 366(h) defines "title 11 or similar case" as a case under title 11 of the United States Code or "a receivership, foreclosure, or similar proceeding in a Federal or State court." Green Book at 132.

[46] GB § 382(f)(3) at Green Book 195.

[47] GB § 382(f)(4)(A) at Green Book 197.

[48] Green Book at 250 and 56.

[49] Green Book at 250.

The Green Book rules applicable to title 11 proceedings may or may not be overly generous. Limiting their application to formal title 11 or similar cases is unfortunate. To preserve NOLs in a workout, GB § 382(f)(4) requires formal bankruptcy proceedings in frequently crowded courts, even where an informal out-of-court workout could achieve the same results in a more timely, less expensive and more efficient fashion. A more sensible rule would dispense with the requirement of a formal proceeding and would relieve the already overburdened bankruptcy courts of the added chore of passing on plans that could have been effected out of court. Loss companies, such as L, cannot benefit by the delays and costs inherent in title 11 or similar cases. No case has been made for excluding informal arrangements. Surely adequate safeguards can be devised to save the trouble and costs formal title 11 proceedings entail. The qualified workout exception in Code § 108(e)(10), the effective date of which is postponed until the 1976 version of Code § 382 becomes effective,[50] provides a good working draft for a more enlightened law.

If one accepts the premise that L's creditors are the true parties in interest who have sustained the economic loss from L's operations, the ABA Draft and the Green Book both properly view the stock-for-debt conversion as not triggering a change in control for Code § 382 purposes. But, as discussed in more detail later, if the exchanging creditor is not the creditor who shouldered the economic risk (and sustained the economic loss) but instead is a recent purchaser of the L debt at distressed prices, the exchanging creditor's position is less sympathetic. The recent purchaser's entitlement to exemption from change of control treatment is tenuous at best. The ABA Draft deals with this possibility by including in purchases that may effect a change in control, any acquisition of L stock by a creditor if the claim was created or acquired principally for the purpose of obtaining L stock.

By contrast, GB § 382(f)(4)(A) apparently permits recent purchasers of L receivables—even purchasers who purchased with the view to exchanging those recently purchased receivables for L stock in the title 11 proceeding—to be excluded from the change of control count. If L's shareholders and creditors "(immediately before the change) own (immediately after the change)" voting and value control of the L stock, there will be no deemed ownership change and the "section 382 limitations" will not be applied to L.

Where, in a title 11 proceeding, L's old and cold creditors become L's controlling shareholders, both the ABA Draft and the Green Book appear to reach the right result—a result not apt to be contested by the bankruptcy bar or others. Where the old and cold creditors leave the scene and a purchaser of their claims steps in and becomes L's controlling stockholder, a different result may be more appropriate. That issue is discussed later under III, P: A New Purchaser.

Tax treatment of L's creditors

In the stock-for-debt exchange, L's unsecured creditors will recognize gain or loss on the exchange of their creditor interests for L stock.[51] If the creditor has previously written off the L debt he holds as worthless, the creditor will recognize gain to the extent of the fair market value of the L stock he receives. Where no previous write-offs have been taken, the creditor will probably recognize a loss on the exchange. The L stock received by the creditor will be treated as Code § 1245 recapture property to the extent the creditor charged any previous deductions as worthless bad debts or charged a bad debt reserve account or claimed an ordinary loss on the exchange of his debt for L stock.[52]

If the L creditors are not L security holders, the exchange of their short-term L notes and L accounts receivable will not qualify as either a tax-free recapitalization described in Code § 368(a)(1)(E)[53] or as a tax-free corporate organization described in Code § 351.[54]

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[50] See 1984 Blue Book at 168.

[51] Code § 351(d)(2) renders Code § 351 unavailable to creditors, other than security holders, who participate in exchanges of debt for controlling stock interests in the debtor.

[52] Code § 108(e)(7).

[53] To qualify as an (E) reorganization, the L debtors would have to exchange securities for stock. See Bacon, "Rescue Planning for the Failing or Bankrupt Company," 61 Taxes 931 (1983); Rev. Rul. 59-222, 1959-1 C.B. 80 and Asofsky/NYU, 41 NYU Tax Inst. 5-39 (1983).

[54] Code § 351(d)(2) treats indebtedness of the transferee corporation not evidenced by a security as not qualifying as "property" for Code § 351 exchanges.

Under present law, L's creditors presumably are new stockholders [55] who have acquired their stock by a "purchase" [56] that triggers the operation of Code § 382 if L "has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership." [57]

II. Contributions to capital: Suppose L's only creditors are its stockholders. To find L's losses, L's stockholders lend the required monies to L (or purchased the L indebtedness from L's trade creditors). L's balance sheet would appear:

L balance sheet

Operating assets	$100,000
Liabilities to stockholders	1,000,000
Capital stock	500,000
Accumulated Deficit (NOL's)	(1,400,000)
Total	100,000

If, in the title 11 proceeding, the L stockholders contribute their debt to L, L may be required to recognize cancellation of indebtedness income.

Code § 108(e)(6) provides: Indebtedness contributed to capital. For purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital—

(A) section 118 shall not apply, but

(B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

Thus, if L's shareholders had paid $1,000,000 for their L debt, L would be deemed to have paid $1,000,000 to retire the debt, and no cancellation of indebtedness income would be realized. But, if the L shareholders' basis in their L debt was less than $1,000,000, say $250,000,[58] L would realize $750,000 of cancellation of indebtedness income on the contribution.[59]

The Code does not provide any guidance as to when the tax attracting contribution to capital rule of Code § 108(e)(6) overrides the tax exempting stock-for-debt rule of Code § 108(e)(10)(B).[60]

Example: L's creditors hold $1 million of L debt with a basis of $250,000. If the creditors contribute/exchange their debt for L stock, is the transaction to be viewed as a contribution to L's capital; a stock-for-debt exchange or part contribution, part exchange?

One commentator suggests stock-for-debt treatment will prevail only where the stock isuance is economically significant."[61] Under his analysis, where L is insolvent or involved in a title 11 proceeding and the contribution of L's debt is made by L's sole stockholder or pro rata by L's stockholders, even if L exchanges stock for the debt, the cancellation of indebtedness rule and not the stock-for-debt rule would govern.[62] That rule is perverse. Any L creditor, other than L's stockholder—wheth-

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[55] But see *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942). At least some commentators assert that ownership for continuity purposes does not constitute shareholder status for Code § 382 purposes. Mirsky and Willens, "The Bankruptcy Tax Act of 1980: A Survey," 59 Taxes 145, 146 (1981).

[56] "For purposes of I.R.C. § 382(a), the term 'purchase' is defined generally as the acquisition from an unrelated person of stock the basis of which is determined solely by reference to its cost to the holder. . . . [U]nder the Bankruptcy Tax Act, by virtue of § 351(d)(2), the claims of nonsecurity creditors do not constitute property for purposes of § 351. Thus, the term purchase for purposes of § 382(a) includes an acquisition of stock by creditors who are not security holders, irrespective of whether such creditors obtain control of the debtor within the meaning of § 368(c)." Tatlock, 466 T.M., "Bankruptcy and Insolvency: Tax Aspects and Procedure" A-58.

[57] Code § 382(a)(1)(C).

[58] The shareholders' $250,000 basis could be less than the $1,000,000 face amount of the debt by virtue of varying transactions. Fair market values of less than face could have been established on the death of a former debt holder under Code § 1014; basis could have been reduced for S corporation losses taken under Code § 1367(b)(2); or the debt could have been purchased from other creditors for less than face in a transaction outside the "related party rule" of Code § 108(e)(4). *See* Asofsky/St. Louis, 27 St. Louis U.L.J. 583, 611-13 (1983).

[59] L's realized gain would reduce L's tax attributes under Code § 108(b) or if the indebtedness is qualified business indebtedness, L may reduce the tax basis of its property under Code §§ 108(c) and 1017.

[60] Tatlock, 466 T.M., "Bankruptcy and Insolvency: Tax Aspects and Procedure" A-52.

[61] Id.

[62] Id. Asofsky agrees: To illustrate, if the sole stockholder of a corporation holds his corporation's debt and cancels it, the transaction would appear to be a contribution to capital regardless

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er old and cold or new and hot—could engage L in a stock-for-debt exchange without triggering cancellation of indebtedness income, but if the exchanging creditor is L's sole stockholder who sustained the economic loss attributable to L's losses, L will have gain recognition under Code § 108(e)(6).[63] The Senate Finance Committee Report on the Bankruptcy Tax Act provides limited guidance as to whether a debt cancellation is a taxable contribution or a nontaxable exchange.

Whether a cancellation of indebtedness by a shareholder-creditor is a contribution to capital depends upon the facts of the particular case. In order for the contribution to capital rule to apply, the shareholder's action in cancelling the debt must be related to his status as a shareholder. If the shareholder-creditor acts merely as a creditor attempting to maximize the satisfaction of a claim, such as where the stock and bonds are publicly held and the creditor simply happens also to be a shareholder, the cancellation of the indebtedness on exchange of the bonds for stock is not to be treated as a contribution to capital by a shareholder for purposes of this rule.[64]

The differing results reached in similar transactions involving contributions or exchanges of debt for stock cannot be justified, especially after the 1984 enactment of Code § 108(e)(10) terminating the stock-for-debt exception to income recognition in all cases save insolvencies and title II proceedings. If the stock-for-debt exception is to be continued in title II and insolvency cases, a comparable exception for contributed debt would be appropriate.

III. P: A new purchaser: Assume L's new owner, P, rather than being an old and cold L creditor, is a stranger to L, and enters the picture only after L files for reorganization under title II. All former L shareholders and creditors are eliminated; the shareholders receive nothing; their stock is cancelled; the L creditors receive 15¢ for every dollar of proven claims, the 15¢ being furnished by P in exchange for newly issued L stock.

If the old L creditors are "satisfied" by L's payment of 15¢ on every dollar, L will realize $850,000 of cancellation of indebtedness income [liability satisfied ($1,000,000) less payment ($150,000)]. L does not recognize that cancellation of indebtedness income because Code § 108(a)(1) exonerates discharge of indebtedness income recognition where the discharge occurs (i) in a title II case or (ii) outside formal bankruptcy proceedings where the taxpayer is insolvent (to the extent of the insolvency)[65] or (iii) the indebtedness discharged is "qualified business indebtedness" described in Code § 108(d)(4). Generally, the amount of discharge of indebtedness income that is excluded from gross income under Code § 108(a) would reduce L's NOL dollar for dollar. Code § 108(b). Under these facts, L's NOL would be reduced by $850,000.

If instead of cancelling their indebtedness, the old L creditors exchange their debt for L stock or sell their claims to P who then, as part of a plan of reorganization described in Code § 368(a)(1)(G), exchanges those claims for L stock, the exchange is not one in which cancellation of indebtedness income is realized by L.[66]

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of the fact that additional stock of the debtor corporation is issued. If there is any strong policy behind the contribution to capital rule, it would seem that this type of case calls for the application of that policy. On the other hand, a transaction involving a minority stockholder should seemingly call for the application of the stock for debt rule, except in a case where all of the stockholders are engaging in similar transactions pro rata.

[63] Code § 108(e)(6) reverses the holding in *Putoma Corp.* v. *Commissioner,* 601 F.2d 734 (5th Cir. 1979), that no cancellation of income is realized where shareholder debt is cancelled as a contribution to capital. S. Rep. No. 1035, 96th Cong., 2d Sess. at 19, N 22 (1980).

[64] Id.

[65] "[D]ebtors in insolvency proceedings outside federal bankruptcy court will be entitled to [discharge of indebtedness] exclusion only to the extent of actual insolvency, i.e., the amount by which liabilities exceed the fair market value of assets." Asofsky/NYU 41 NYU Tax Inst. at 5–43 (1982).

[66] The textual statement assumes the exchanges will qualify as stock-for-debt exchanges and will not be treated as contributions to capital. *Id.* at 5–28. Non-recognition at the shareholder and creditor level is limited to L's shareholders and security holders who exchange their instruments for the acquiring corporation's stock and securities. Id. at 5–29. "[T]he debtor's issuance of stock to the creditors should eliminate any debt forgiveness effects and any reduction in loss carryovers regardless of whether the stock is allocated to (and deemed exchanged for) securities or short-term claims. To the extent any other creditors are paid in cash at less than the full amount of their claims, the company [L] would incur forgiveness of indebtedness." See Bacon, "Rescue Planning for the Failing or Bankrupt Company," 61 Taxes 931, 942 (1983). Some writers have argued that stock-for-debt exchanges are limited to exchanges by "historic" creditors. See Remeikis, "Debt/Equity Considerations and Deep Discount Bonds." 41 NYU Tax Inst. 6–24 to 31, and Berger, N. 5 supra at 694. These comments, critical of the Capento holding "in which the equity-for-debt rule was applied to an exchange that did not involve an historic creditor" [Berger at 694], addressed and criticized the wave of exchanges by solvent corporations of their common stock for their deeply market discounted bonds ("debt-equity swaps") pursuant to pre-

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The ABA Draft would not treat as favorably a purchaser of L debt, who purchased L debt for the principal purpose of exchanging it for L stock. Under the ABA Draft, if L's old and cold creditors exchanged their debt for L stock in a title 11 proceeding—either in a stock-for-debt exchange or in (G) reorganization—there would be no diminution of L's NOLs. Upon the subsequent sale of that stock to P, P's purchase would be a change in control of L and would bring into play the ABA's NOL limitations, i.e., 2% of L's value per month for 60 months. Alternatively, under the ABA Draft, if P purchased the L debt with the principal purpose of converting the debt into L stock, P's subsequent exchange of the debt for L stock would constitute a change in control, triggering the NOL limitations.[67]

The Green Book presumably would permit L to fully utilize its NOLs after P has (i) purchased all the L debt from L's creditors and (ii) subsequently exchanged that newly purchased debt for L stock in the title 11 proceedings, either in a stock-for-debt exchange or in a (G) reorganization,[68] even where P's purchase of debt was with the view to acquiring control of L. The Green Book requires merely that there be (i) a title 11 or similar case and (ii) that L's shareholders and creditors immediately before the change in control be the L controlling shareholders immediately after the change in control. P may arrive on the scene quite late and become the beneficial owner of L's unreduced $1,400,000 loss carryover with an investment of $150,000 or less. That inescapable Green Book Draft conclusion is wrong.

In bankruptcy settings, the Green Book violates the neutrality principle. Under the neutrality principle and the Green Book, if P purchases control of L immediately before the title 11 proceeding, L's NOLs each year would be limited to the value of the old loss corporation at the time of P's acquisition, multiplied by the "Federal long-term interest rate" (plus or minus the exceptions for built-in gains and losses).[69] But, under the Green Book, if P acquires control of L during a title 11 proceeding by purchasing L's debt and then exchanging it for L stock, L's NOLs may be deducted in full, immediately.[70]

Under the Green Book, if P gains control of L by purchasing less than a controlling L stock interest and debt [71] or solely L debt immediately before a title 11 proceeding is instituted and in the title 11 proceeding acquires control of L, presumably there would be no NOL reduction. This appears to be so, even where L enters its title 11 proceeding with a group of shareholders and creditors that does not include P, or P enters the proceeding as a noncontrolling shareholder and emerges as L's sole shareholder. These results are not crystal clear in the reading of GB § 382(f)(4) or the Green Book's accompanying explanation. But they do seem probable. It appears that one or more minority shareholders of the old loss corporation may emerge as the sole shareholder of the title 11 reorganized corporation (new loss corporation) and qualify for the favored title 11 stock-for-debt treatment. And if it not be so, purchases immediately before or during the title 11 proceeding of L creditor claims, which claims are then exchanged for a controlling stock interest in L, appear to fall well within the contemplation of GB § 382(f)(4). The ABA Draft would reach a different result where the L debt is purchased by P, if the debt is (i) at least two years old and (ii) is converted into L stock. The "acquisition value"would include both the cost of P's direct stock purchase and the lower of P's cost of the L debt (or its fair market value). [72]

Aside from arguments that NOLs need to be preserved to encourage prospective Ps to fund title 11 rehabilitations, there is little to commend a rule that so heavily favors purchasers of a business with NOLs in formal title 11 proceedings. The generally favorable treatment afforded title 11 proceedings could be continued for the old loss corporation's shareholders and creditors without providing P with windfall results by adding the following sentence to GB § 382(f)(4)(A)(ii):

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arrangement with Salomon Brothers or other investment bankers. Id. at 677. Code § 108(e)(10)(A) ended debt-equity swaps for solvent companies, while Code § 108(e)(10)(B) preserves the stock-for-debt exception in title II cases and for insolvent debtors. See Bryan "Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps". 63 Texas L. Rev. 89 (1984).

[67] ABA Draft § 382(c)(2)(C).

[68] GB § 382(f)(4) at Green Book 196.

[69] GB § 382(b) at Green Book 187.

[70] If P purchases control after the title 11 change of control has been effected, GB § 382(f)(4)(C) at Green Book 197 provides that if P's purchase is withing two years of a title 11 change of control, L's NOL carryovers shall be zero.

[71] The amount of L stock purchased must be less than control to avoid a "premature" reduction of NOLs under GB § 382(a).

[72] ABA Draft § 382(d).

"For purposes of this paragraph the terms "shareholders and creditors of such corporation (immediately before the change)" do not include persons whose acquisition of the stock or debt was part of a plan, a principal purpose of which, was to obtain control of such corporation.[73]

A second solution to the potential abuse of recently purchased L debt being exchanged in stock-for-debt transactions exempted from the normal tax attribute reduction rules of Code § 108(b) is suggested by Code § 108(e)(6). That section looks to the shareholder's adjusted basis in contributed debt to fix the debtor corporation's discharge of indebtedness income.[74] Code § 108(b)'s tax attribute reduction rules could be made applicable to title 11 and insolvency stock-for-debt transactions where the exchanged debt has been acquired in a taxable transaction within two years of the exchange. With these principles in mind, Code § 108(e)(8) could be amended by adding a subparagraph (C) to read:

"(8) Stock-for-debt exception not to apply in certain cases. For purposes of determining income of the debtor from discharge of indebtedness, the stock-for-debt exception shall not apply—"

"(C) to debt purchased (or otherwise acquired by the exchanging debtholder in a transaction in which adjusted basis for the debt is determined in whole or in part other than by reference to another's basis[*] within two years of the exchange date. Where the stock-for-debt exception does not apply, the debtor corporation shall be deemed to have satisfied the exchange indebtedness with an amount of money equal to the exchanging creditor's adjusted basis in the indebtedness."

Under this rule, L's old and cold creditors could take over L and enjoy its undiminished net operating losses and other tax attributes, while effectively relegating P (a new debt purchaser) to the limitations imposed under the normal operation of the neutrality rule. Code § 108(e)(1) could be repealed. Debt-equity swaps would be thwarted by the two year holding requirement. Of greater significance and value, the stock-for-debt exception could be restored to transactions outside title 11. If Congress wants to continue to limit favored stock-for-debt treatment to title 11 and insolvency cases, Code § 108(e)(10)(B) could be amended to conform to the suggested Code § 108(e)(8)(C) provision.

Where L sustains its NOLs shortly after its formation and none of its creditors meet the two year old and cold standard, the suggested amendments to Code §§ 108(e)(8) and (10) may not work properly. Relief could be provided by shortening the period for start-up companies (e.g., 50% of business life)[75] or by adding an exemption for nontax motivated debt acquisitions. Alternatively, many of the perceived hardships could be alleviated if the exchanging creditor's "unadjusted basis," rather than his adjusted basis, is used to measure the debtor corporation's discharge of indebtedness income.[76] The exchanging debtholder would, of course, recognize gain based on his adjusted basis, but there is no requirement that the exchanging creditor's adjusted basis (rather than unadjusted basis) must be used to determine the debtor corporation's discharge of indebtedness income.

GB § 382(f)(4)(A)(ii) should also be amended to clarify the status of title 11 proceedings where a minority of L's shareholders and creditors emerge as L's controlling shareholder group. If, for example, P owns 1% of L's stock or debt prior to the title

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[73] The House version of the 1980 Bankruptcy Tax Act contained a similar provision amending Code § 382(d). "For purposes of [Section 382(a)], stock in the corporation which is acquired by a security holder or creditor in exchange for the extinguishment or relinquishment (in whole or in part) of a claim against the corporation in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) shall be treated as not acquired by purchase, unless the claim was acquired for the purpose of acquiring such stock." H.R. 5043 § 2(d) adding Code § 382(d)(1) [never enacted].

[74] The House version of the Bankruptcy Tax Act of 1980 applied this rule to exchanges of stock for nonsecurity debt. Under its section 108(f)(1)(A), non-security debt satisfied with stock was deemed paid with money equal to the value of the stock. See Eustice, "Cancellation of Indebtedness REdux: The Bankruptcy Tax Act of 1980 Proposals—Corporate Aspects," 36 Tax L. Rev. 1 (1980).

[*] Under Regulations prescribed by the Secretary, where adjusted basis is determined by reference to another's basis, the referenced basis must also satisfy the "not determined . . . other than by reference to another's basis" condition. Where debt is acquired from a decedent, the date of purchase or acquisition from a decedent, the date of purchase or acquisition shall be the decedent's date of purchase or acquisition.

[75] Cf. Code § 1374(c)(2) excepting from the special capital gains tax gains derived by an S corporation that has been in existence for less than 4 years but had an S election in effect for each of its taxable years.

[76] Where the adjusted basis for debt has been reduced by subchapter S losses [Code § 1367(b)(2)] or charged off by a creditor as a partially worthless bad debt [Code § 166(a)(2)], but not sold to a new purchaser "unadjusted basis" may be a more fair measure of the corporation's discharge of indebtedness income.

11 proceeding and as part of that proceeding contributes funds sufficient to retire all other shares and debt, would P be deemed a shareholder or creditor (immediately before the change) who controls L (immediately after the change)? If outside purchasers are not to be permitted to take over L's loss carryovers to an extent disproportionate to the purchase price they pay, small L creditors or shareholders should be treated no more favorably. This feature could be included in the statutory scheme by requiring a threshold of 50% or 33⅓% or 25% continuity before permitting a bankruptcy exception to the normal neutrality rules. If owners of the threshold amount of L's debt and equity (measured by value) before the institution of the title 11 proceedings own the controlling interest in L after the change, then GB § 382(f)(4) would exonerate the gain from recognition—regardless of how much property threshold owners contributed to L in the title 11 proceeding to gain their after-change control. But if P, the purchaser, does not, before the commencement of the title 11 proceedings, own the requisite threshold interest in L, P's acquisition would be deemed a purchase of control within the contemplation of GB § 382(a) and subject to the limitations of GB § 382(b).

The interaction of the bankruptcy tax provisions and Code § 382 is pervasive and perplexing. The stock-for-debt exception to the cancellation of indebtedness income rule stands at the center of the insolvency tax-playing field. Assuming its continuing vitality in title 11 and insolvency cases, a rational Code § 382 policy must permit continuing L shareholders and creditors to preserve L's NOLs, undiminished, while treating purchases of bankrupt companies no more favorably than purchases of other companies that possess favorable tax attributes, i.e., all purchases should be subject to the application of the neutrality principled net operating loss carryover rules.

The stock-for-debt exception to the tax attribute reduction rules of Code § 108 is both a political reality and an appropriate tax policy. Creditors who sustain the economic brunt of a debtor's losses may well argue that they should be treated no less favorably than equity holders who sustain economic losses. Both should have the benefit of undiminished tax loss (or other attribute) carryovers. The corollary to that principle is that purchases of a debtor's debt, at less than its face value, followed by its exchange for debtor's stock should be treated no more favorably than direct purchases of the debtor's stock.

The Green Book would provide creditors an undue advantage where cheaply (and recently) purchased debt is exchanged for control of the loss corporation. That untoward result can and should be eliminated from the proposal.

AILING THRIFTS

A special problem closely associated with insolvent and bankrupt companies concerns insolvent or ailing thrifts—savings and loan associations or savings banks whose losses and built-in losses threaten their viability. Greatly simplified, when thrifts have made long-term fixed interest rate loans at rates that are significantly less than the current cost of short-term borrowings incurred to carry those loans, continuing losses will materialize and continue. The people in the thrift business call this state of affairs "disintermediation." We tax lawyers call it a condition that produces NOLs and built-in losses.

Code § 382 and other Federal policies traditionally have treated purchasers of ailing thrifts generously. Typically, a profitable financial institution "agrees to assume a failing thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to utilize the failing thrift's tax losses and assume the thrift's basis in its assets, which typically consist primarily of mortgage loans with a book value substantially in excess of market value." [77]

Under present Code § 383(a), the purchase of all the stock of an ailing thrift does not cause the thrift to suffer any diminution in its NOLs, provided the thrift continues its business.[78] Where the acquisition results from a reorganization described in Code § 368(a)(3)(D)(ii),[79] Code § 382(b)(7) provides the requisite continuity-of-interest

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[77] "The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity" at 250 (1985) ("The Reagan Proposals").

[78] See Code § 382(a)(1)(A),(B) and (C).

[79] Code § 368(a)(3)(D)(ii), enacted in 1981 to facilitate mergers and reorganizations of ailing thrifts, applies to mutual savings banks, domestic building and loan associations and nonprofit, nonstock cooperative banks that engage in reorganizations that otherwise qualify as (G) reorganizations, except that no stock or securities of the acquiring corporation are issued or distributed provided—

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to prevent any reduction in the thrift's NOLS by treating depositors as stockholders and the value of their deposits as the value of stock. Neither the Green Book nor the ABA Draft provides that extraordinary degree of exemption from tax attribute reduction to thrifts—nor should they.

The Reagan Proposals would repeal Code § 368(a)(3)(D)(ii) for acquisitions occurring after December 31, 1990. The Reagan Proposals at 249–51.

Under the ABA Draft, if control of a stock thrift is acquired by a new purchaser or if a mutual thrift is converted into a stock thrift whose control is then acquired by a purchaser, the NOLs (donominated as "section 382 attributes" in the ABA Draft) would be cut down to 120% of the acquisition price. The problem with that formulation is that if does not deal effectively with the realities of saving failing thrifts. Most often what is required to safe a thrift is an infusion of capital into a failing thrift that has a large negative net worth. Depending upon the extent and type of aid the regulatory agencies are willing to provide (e.g., low or no interest loans or preferred stock purchases or outright capital contributions), the purchaser's required infusion can vary from a relatively small portion of deposits to a rather large one.

In the typical case, by definition, the "acquisition value" of the thrift is nonexistent or very small at best. Typically, no consideration is paid to the thirift's former shareholders or depositors. Instead, all monies paid to acquire control of the thrift go—at the direction of the regulatory authorities—to the target thrift itself. Those payments by the purchaser would—in the case of any other type of loss target corporation—be viewed as assets contributed to the target within two years of the acquisition or as post-acquisition contributions, neither of which contributions would count as "acquisition value" that fixes the amount (in the case of the ABA Draft) or the annual allowance (in the case of the Green Book) of available NOL utilization. In other words, applying the normal neutrality formula, the allowable NOL would be zero, even if millions of dollars are paid by the purchaser (to the target thrift) for a controlling stock interest.

Balancing the equities between the need to salvage troubled thrifts and the desirability of applying the neutrality principle in the same manner to all acquisitions is not easy or comfortable. Where the principal motive for acquiring the troubled thrift is not to secure its tax attributes, but rather to profit from its deposit base or turn-around potential, a special rule can be crafted that would provide purchasers of troubled thrifts with the same benefits purchasers of other loss companies enjoys, without prompting tax motivated transactions. Although the fashioned rule would not strictly adhere to the neutrality principle in that it would grant the purchaser of a controlling interest in a troubled thrift greater tax benefits than the seller was likely to enjoy, given the special status of troubled thrifts, the deviation seems justified. I propose the following statutory rule:

"GB § 382(f)(4)(D). Troubled Thrifts. If, pursuant to a transaction consummated under the auspices of a Federal or State agency described in section 368(a)(3)(D), control of a financial institution (the "old loss company") is acquired by one or more purchasers (or a transaction under section 368(a)(3)(D)(ii) is consummated), the value of the old loss corporation before the change shall be deemed to include (i) all amounts paid by the purchaser (or acquiring corporation) to acquire control of the loss corporation and (ii) all amounts contributed by the purchaser to the capital of the old loss company within two years after the change in control pursuant to the terms of the plan as approved by the Board."

If this provision is enacted, purchasers of troubled thrifts will be able to treat amounts paid to the target as part of their purchase price and a component of the measuring acquisition value. That purchasers will be entitled to deduct a percentage of their purchase price will not encourage trafficking in troubled thrifts because the value of the tax attributes will always be less than the amount paid for them. No longer will purchasers of troubled thrifts be entitled to utilize NOLs and other tax attributes aggregating many times the purchase price of the troubled thrift. And, the formulation would not deny good faith purchasers of troubled thrifts the right to use the thrift's NOLs to thie extent the purchaser "pays" for the stock it pur-

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"(I) The acquiring corporation acquires substantially all the assets of the target thrift and the transferred properties received by the target thrift (if any) are distributed in pursuance of the plan;

"(II) The acquiring corporation assumes substantially all of the target's liabilities; and

"(III) The Federal Home Loan Bank Board or the Federal Savings and Loan Insurance Corporation or equivalent State authority certifies the reorganization was necessitated by the failing economic health of the target, i.e., the target thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future."

chases from the thrift. The proposed statutory solution should satisfy all but the most doctrinaire—whether they be proponents for continuing the present rules permitting unlimited carryovers to purchasers of troubled thrifts or those who would vary not an inch from the neutrality principle limiting the new owner's loss utilization to that which the old owners could reasonably have been expected to enjoy.

Troubled thrifts present special problems and are the proper focus of special concern and require special solutions in the tax attribute carryover area. Congress should recognize these needs and respond with thoughtful tax legislation.

NOL SHELTERS, A BURGEONING INDUSTRY

If and to the extent General Utilities is repealed by the enactment of the Green Book proposals [80] pressure to use NOLs to shelter otherwise taxable corporate gain will intensify. So long as net operating loss carryovers are permitted to level the ups and downs of American's corporations, corporations will be tempted to use their NOLs to shelter the income of other taxpayers.

Example: A owns the stock of T, an operating real estate corporation, whose sole asset is a building, having a fair market value of $20 million and an adjusted basis of $10 million. T enters into a contract to sell its building to a third party purchaser for $20 million. After the enactment of the Green Book provisions repealing General Utilities (Code §§ 336 and 337), A estimates that T will incur a tax of approximately $3 million on the contemplated sale.[81] Thus, A can anticipate receiving $17 million in net after corporate tax proceeds upon T's liquidation.

Instead of consummating the sale in the manner outlined, A sells, for $18 million, all his T stock to L, a loss corporation with adequate carryovers to shelter T's incipient gain in L's consolidated return.

The net effect of these transactions is to eliminate the corporate tax that would have been paid by T, increase the amount A realizes on the sale or exchange of his T stock from $17 million to $18 million and permit L to barter $10 million of its NOL for a $2 million cash return.

These results obtain under present laws, although the general availability of Code §§ 336 and 337 render resort to this procedure unnecessary in most cases. Under present law, where the target corporation owns property subject to recapture, it may seek an NOL partner to absorb the incipient recapture gain. But, these situations are relatively infrequent as compared to the number of similar transactions that would be effected following the enactment of the Green Book provisions repealing General Utilities. If the Green Book merger and acquisition provisions are enacted, T can transfer wanted assets to L in a carryover basis transaction and receive in exchange L notes or cash. L can use its NOLs to zero out the corporate tax on the gain. The results may be even more troubling where control of the loss corporation is purchased or acquired by A in a title 11 proceeding, utilizing the stock-for-debt exchange procedure to preserve L's NOLs. A would then cause T to transfer the building to L in a carryover basis transaction and proceed to consummate the sale of the building to the buyer.

It is unlikely that any rules can be crafted that would permit loss companies to rehabilate themselves by offsetting their prior losses against their future incomes, while preventing the economic equivalent of a transfer of tax attributes from loss companies to profitable companies at some negotiated price. Given these realities, Congress would do well to enact promptly the best possible net operating loss provision. Existing law will not block these transactions. The Green Book and ABA Draft provide the best hope for the future, even if they be less than perfect.

CONCLUSION

The time to fix Code §§ 382 and 383 is now. The studies—particularly the ABA Draft and the Green Book—show the way. While the Green Book and ABA Draft generally follow the same path, the ABA Draft is preferable in at least four respects—(i) its familiar form and relative brevity; (ii) its realistic use of equity, rather than debt, return assumptions to set loss utilization rates; (iii) its permitted conversion of old and cold debt to equity; and (iv) its avoiding exceptions for investment companies. Now is the time to bring rationality to this important area. Although title 11 proceedings, insolvent companies and ailing thrifts present especially difficult problems, particularly as Code § 382 interacts with Code § 108, those areas of concern can be addressed and resolved in a manner consistent with the neutrality principle, recognizing the overall goals that are to be achieved through the Internal Revenue Code.

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[80] GB § 121, Green Book at 142.

[81] T's long-term capital gain rate is 28%; additional recapture taxes under Code §§ 1245, 1250 and Code § 291 can increase the effective tax rate well above 30%.

STATEMENT OF NICHOLAS TOMASULO, SILVERSTEIN & MULLENS, WASHINGTON, DC

Mr. TOMASULO. Mr. Jacobs mentioned the neutrality principle. Under the neutrality principle, if a corporation has all business assets or has all investment assets, the two corporations are treated exactly alike. Whereas, in the real world, the business assets show a business history, and the investment assets do not. For this reason it is essential to look at one of the really early cases, which is the case of Alprosa watch. In that case—all of the stock of a glove company was purchased, and the glove manufacturing assets were sold, and a watch business was put into this corporation. The court held, amazingly, that the new corporation, the new taxpayer, was the same as the old, simply because the charter was the same.

Now, if we take that kind of formality, then just as surely as the night follows the day, you will see ads in the New York Times something like this: "Stock of corporation having 1943 tax loss deduction, $120,000, sole assets are $80,000 in cash and equivalent." That ad appeared in 1943 in the New York Times and was one of the reasons why section 129 of the 1939 code, which later became section 269 of the 1954 code, was enacted.

Now, would it not really embarrass the Treasury and embarrass this committee to see ads like that? Is not that really safe harbor leasing all over again?

I want to make just two points fairly forcefully. I am an old legislative man, I worked here many years on the joint committee. I believe that the public simply will not accept the Alprosa watch doctrine, simply will not accept it, no matter what the bar association says, no matter what the ALI says.

On the other hand, there never has been—there never, never has been—any objection to allowing losses in a reasonable amount when a going business is acquired.

In the real world, however, there will sometimes be business assets and also investments. Now, nothing is simpler than deducting the investments from the business assets—and this is not a sanction, this is not a penalty, because if a man pays $1 million for only business assets and the losses, he gets losses based on $1 million. On the other hand, if he $1,300,000 for $1 million in business assets and $300,000 for investments, then you deduct the investments, and you are back where you started from—you've got just a perfect filter, a perfect filter which has the same effect as if you had purchased two corporations.

Now, with this I will close. In other words, the neutrality principle is really a return to the formality of Alprosa watch and also to safe harbor leasing, to the basic principle of safe harbor leasing.

Senator CHAFEE. All right. Well, thank you very much.

Mr. Bacon.

[Mr. Tomasulo's written testimony follows:]

PREPARED STATEMENT OF NICHOLAS TOMASULO

Net Operating Losses

This issue has a long intellectual and political history. On September 11, 1958, the "Subchapter C Advisory Group"[1] submitted its "Revised Report" to the Committee on Ways and Means (GPO-1958-33066). This report states, in part, in the last paragraph on page 90:

> "The advisory group viewed the problem as basically one of differentiating between the acquisition of a going business, the tax attributes of which would be incidental, and the mere acquisition of the tax attributes themselves."

This brief statement sets forth with great clarity and force what the public perception of a fair and equitable statute is in this area. That perception is that

> since loss carryovers are an averaging device, the taxpayer which exploits the loss must be the same as the taxpayer which incurred it, and a corporation as to which there has been a dramatic change in stock ownership is the same taxpayer as it was before such change, to the extent, and only to the extent, that it continues to own and exploit the same business assets as it did before such change.

As originally suggested by the Advisory Group, we intend, of course, to begin with the purchase price of the stock to place a cap on the permissible losses (which may be either a gross amount or a certain percentage per year).

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[1] Norris Darrell, Chair; Kenneth W. Gemmell; C. Rudolf Peterson; Samuel J. Lanahan; Edwin S. Cohen; Leonard L. Silverstein; and Marvin K. Collie.

However, a rational operating loss statute must distinguish between the "good" case and the "bad" cases. The "good" case, called the normal case, is one in which a going business is acquired, the tax losses of which are incidental. Thus it is fair to say that a corporation which owned only widget producing assets before the stock transfer is the same taxpayer to the extent it continues to own and exploit such assets.

There are three types of "bad" cases which we will for convenience call "investment type," "*Alprosa Watch*-type" (11 TC 40-1948), and "pre-sale stuffing type."

> (a) the bad case (investment-type) is one in which there is the acquisition of the charter of a loss corporation, which owns only investments, solely to use such corporation's tax losses. In such a case it is obvious that the corporation after the change of ownership is not the same taxpayer as it was before. Clearly, to permit one taxpayer to use the loss of another is evil, inequitable, and a silly waste of revenue. (These losses clearly do not exist under present law in the case of purchases. See Rev. Rul 67-186, 1967-2 C.B. 81.) In such a case we call the corporation a "Zombie" corporation to the extent it owns investments rather than business assets.[2]

2/ Because after the change in ownership a different (new) taxpayer uses the charter of the pre-change taxpayer, just as the voodoo spirit uses the body of a dead stranger.

(b) the bad case (Alprosa Watch-type) is also one in which the corporation acquired has business assets at the time of the change in ownership, but all these assets are disposed of (by sale or otherwise) after such change. Just as in the investment-type case, it is absurd to consider the corporation the same taxpayer after the sale of the business assets. In such a case, we again call the corporation a Zombie corporation to the extent it sells business assets after the stock transfer. [The Alprosa Watch case is the original "Neutrality Principle" or "Capital Fund" decision. It held, back in 1948, that a loss survives as long as the charter survives, all other external reality being disregarded. In view of its enormous importance, a short quotation from the opinon appears as appendix A, at the end of this paper.]

(c) the bad case (pre-sale stuffing type) is also one in which shortly before the sale of the stock, business assets, unrelated to the existing corporate businesses, are contributed to the corporation.

There are very few persons indeed who will argue that losses should survive in a 100 percent Zombie corporation, that is, one in which all the business assets are sold. However, the problem remains as to how to handle a corporation which is in part "normal" and in part a "Zombie." It seems to us that this can be done quite simply by subtracting from the purchase price of the stock acquired (a) the investment assets, (b) the proceeds on the sale of business assets after the stock transfer, and (c) contributions to capital before the stock transfer.

Please observe that adjusting the purchase price by subtracting the investments is not, in any sense, a penalty. The objective is merely to keep the losses otherwise allowable from being increased but without diminishing them to any extent. This can be made clear by comparing two corporate sales with the same amount of business assets but only one involving investments:

Sale Involving No Investments

A, an individual, buys 100 percent of the stock of corporation Z for $1,200,000. At the time of the sale, the corporation has $1,000,000 in business assets and no investments. The cap or limitation on losses which may be carried over is determined by reference to the purchase price (unadjusted) of $1,200,000.

Sale Involving Investments

A, an individual, buys 100 percent of the stock of corporation (Z+1) for $2,300,000. At the time of the sale, the corporation has $1,000,000 in business assets (just like corporation Z, above), but also owns $1,100,000 in investments. The adjusted purchase price is now determined as follows:

Unadjusted price	$2,300,000
Investments subtracted	1,100,000
Adjusted Price (to compute cap on losses)	$1,200,000

The above makes it clear that the only reason for subtracting the investments is because their presence is irrelevant in determining the cap on losses. Thus, in the no investment case, the buyer paid $1,200,000 for the business and the losses. On the other hand, in the case involving investments, the buyer also paid $1,200,000 for the business and the losses, but had to pay an additional $1,100,000 for the investments in the corporation. This is not only perfectly fair, but is also consistent with what would result if A purchased two corporations, one with $1,000,000 in business assets only for $1,200,000, and one with $1,100,000 in investments only for $1,100,000.

The Senate Bill

Recapitulating very briefly from what has been said above, it is obvious that a statute intended to prevent the sale of hot-air charter losses must, as a very minimum, include:

> an anti-investment rule, to filter out the portion of the purchase price attributable to investments, and
>
> an anti-Alprosa Watch rule, to filter out the portion of the purchase price attributable to business assets sold after the transfer of the stock, and
>
> an anti-stuffing rule to filter out contributions to capital.

Please observe, once again, that these are not penalty provisions in any sense, but are merely filters, to filter out the portion of the purchase price which is not relevant to the determination of the extent to which the post-sale corporation is the same taxpayer as the pre-sale corporation.

The very weak anti-investment rule provided in the staff bill is that no losses may be carried over if two-thirds or more of the value of the total assets of the old loss corporation is in assets held for investment (Page 195 of the Committee Print). No scale-down is provided if the investments are less than two-thirds in value of the total assets.

Somewhat surprisingly, there is no anti-Alprosa Watch rule in the staff bill. The Technical Committee Report (at page 249 of the Committee Print) does touch on the problem, saying that the step transaction (?) doctrine will be applied if a corporation has agreed to sell its business assets before the stock transfer but delays the sale until after the stock transfer to defeat the anti-investment rule. This certainly would not catch a great number of cases.

In view of the very weak anti-investment rule, and the absence of any anti-Alprosa Watch rule, if the staff proposal is enacted, advertisements to sell loss corporations will again appear in the Wall Street Journal and The New York Times, more or less as follows:

FOR SALE

> LOSS CORPORAION WITH $3,000,000 IN RECENT TAX LOSSES. NOW OWNS $1,000,000 IN INVESTMENT ASSETS AND $1,000,000 IN BUSINESS ASSETS WHICH CAN BE READILY SOLD AFTER THE PURCHASE OF THE STOCK.

Generally similar advertisements have appeared in the past and the public perception has always been that they show conclusively that losses (not business assets) are being bought and sold. Indeed, it was largely because of the embarrassment over such ads that, before the 1954 Code, section 129 of the 1939 Code (now secton 269 of the 1954 Code) was enacted.

Anyone who knows the political history of the issue will see at once that the passage of a statute which permits substantial manipulation will (like safe harbor leasing) result in enormous embarrassment to Congress and the Treasury.

For the above reasons, the staff proposals on the net operating losses ought not to be adopted unless the bill is amended by

> (1) Adding a strong anti-investment rule under which 100 percent of investments would be deducted from the price of the stock, and
>
> (2) Adding a strong anti-Alprosa Watch rule under which losses would be reduced by amounts realized on the sale of business assets after the transfer of the stock.

It must be emphasized again that these are not penalty provisions, but merely filters to keep irrelevant amounts out of the purchase price. Amended in the manner suggested, the staff bill will be perceived by the public as a fair, just and reasonable statute.

One more point is worth mentioning. The staff bill would limit the amount of losses which can be used each year to a percentage of the purchase price, the percentage being in effect the expected return on high-quality bonds. This restriction is unjust in any statute which permits losses to survive only when business assets are acquired. On the other hand, when business assets are not acquired, no losses at all should be permitted. Thus, in either case, there is no analogy to an investment company. Accordingly, the amount of permitted deductible losses should be a fixed dollar amount in all cases.

APPENDIX A

Alprosa Watch Corporation, Petitioner, v. Commissioner of Internal Revenue, Respondent. Docket 12368. Aug. 31, 1948. 11 Tax Court 240 at bottom page 245.

The remaining question in the case is whether Esspi and petitioner are actually the same corporate entity. In view of the established principle that a corporation and its stockholders are separate legal entities, it is recognized that a change in stock ownership does not produce a new corporate personality. Erie Coca Cola Bottling Co., 1 B.T.A. 531; East Coast Motors, Inc., 35 B.T.A. 212. In Northway Securities Co., 23 B.T.A. 532, we held that the petitioner corporation was the same jural person as its so-called predecessor, notwithstanding a change in name, business situs, and type of business. Cf. American Coast Line, Inc. v. Commissioner, 159 Fed. (2d) 665.

In the case before us the corporate name was changed, the locus of business was immediately moved, the corporate stock was acquired by new owners, and the nature of the business was converted from the manufacture and sale of gloves to the purchase and sale of jewelry. The new business activity was authorized by the original certificate of incorporation. Furthermore, it is significant that no steps were taken to liquidate Esspi in the taxable year--in fact, petitioner conducted business for three years' thereafter. In these circumstances, and on the authority of the cited cases, we hold that Esspi Glove Corporation and Alprosa Watch Corporation were the same corporate person for Federal tax purposes.

As it is our conclusion that the petitioner and Esspi Glove Corporation constitute for Federal tax purposes one and the same taxpayer, it follows that petitioner may include in its corporate tax returns for the fiscal year ended June 30, 1943, the income and expenses of the Esspi Corporation for the period July 1, 1942, to June 14, 1943, and is entitled to deduct the net operating losses of the latter company for its prior taxable year ended April 30, 1942. We hold further that petitioner is entitled to the use of the unused excess profits credits of the Esspi Glove Corporation in computing its excess profits credit for the taxable year ended June 30, 1943.

Decision will be entered under Rule 50.

2082N/2106N

STATEMENT OF RICHARD L. BACON, PARTNER, BELL, BOYD & LLOYD, WASHINGTON, DC

Mr. BACON. Mr. Chairman, I am also a former member of the joint committee staff and worked on the 1976 amendments to section 382. That section is the subject of my testimony.

Unlike other witnesses who have testified, my views are not to compliment the staff proposals on net operating losses. I believe they are quite a mess in their present state. I am not saying that, in order to urge you to support trafficking in losses or any tax abuse. All of us believe that we ought to have a sensible set of limitations. Nicholas Tomasulo and I and the American Bar Association Tax Section, have proposed what I think is a better rule than what the staff has come up with.

I think the staff proposals are seriously out of balance in the area of net operating losses, and unfortunately today the witnesses have been preoccupied with the mechanics of how rules would work. You have heard discussions about rates of return and whether 24 percent a year is a proper amount for 5 years. Those kinds of discussions about mechanics tend to take our attention away from fundamental objectives that we should be trying to achieve in this area. Although I am bringing up the rear as a witness here, none of the witnesses who have spoken about net operating losses have really addressed what we are trying to achieve in limiting net operating losses in corporate mergers. The witnesses have also glossed over real, serious differences between the American bar tax section proposal and the staff proposal, as well as differences between the staff proposal and the purchase price proposal that Nicholas and I have proposed.

The staff proposals on net operating losses are unnecessarily restrictive, in limiting losses in the hands of a buyer to an annual limitation each year. In this respect I would say the staff proposals are like throwing a hand grenade into a village and killing innocent civilians, without trying to deal with the real problems that we have. On the other hand, as Nicholas stated a moment ago, the staff proposals are too weak in allowing carryovers based on a loss company's ownership of cash and passive investment assets.

When I talk about the purposes we should try to achieve, we should be clear that trafficking in net operating losses is the fundamental abuse we are trying to prevent. The kind of situation we are trying to prevent with limiting losses in a merger is a case where a company might have a $1 million loss. Somebody could come along and buy that company for $100,000, yet claim a $1 million loss carryover, and that $1 million carryover would produce a tax benefit of $460,000, for which the buyer paid only $100,000. That is the abuse that we are trying to prevent.

I have suggested that we can prevent that kind of result by limiting the losses in the hands of a buyer to the purchase price he pays. So, if he pays $100,000, he only gets $100,000 of losses. That amount of loss will produce a tax benefit of $46,000 at today's rates. Obviously, no one would buy a company primarily to obtain loss carryovers and pay $100,000 if he could only get $46,000 in tax benefits. He would, obviously, have to be paying $54,000 for nontax business assets.

The rule I have proposed is designed to assure automatically that a new owner cannot obtain tax benefits greater than his economic cost to obtain them. This rule will prevent trafficking without any annual limitation based on a rate of return.

If we do our job correctly in limiting the ability of a buyer to buy a company that has only cash or investment assets, and we limit the buyer to carryovers equal to the amount that he paid, we then have eliminated the abuse of trafficking. We need not go further to an academic limitation of the amount of loss that a buyer can use in any one year, any more than we would think of limiting the buyer of a profitable business to the amount that he would be taxable on each year if his company makes more money than what the former owners made.

I think that the staff is using a misguided definition of "neutrality" because the effect of their proposal would be to prevent turnaround situations where a new owner can revive a failing business, and it would also discourage certain kinds of buyers—rather than providing an objective rule for any kind of buyer to come in and buy a company primarily for nontax reasons.

The rest of my summary joins those who have criticized the staff proposals for bankruptcy reorganizations, on the grounds that we should not distinguish between creditors and outside investors who take over a loss company, and also recommending the inclusion in the exceptions from the staff proposals for special rules dealing with supervisory mergers of failed savings and loan associations, which is an offshoot of the bankruptcy area but an extremely important one in today's banking climate.

Thank you.

Senator **CHAFEE**. Well, thank you.

[Mr. Bacon's written testimony follows:]

Statement of Richard L. Bacon
Bell, Boyd & Lloyd, Washington, D.C.

Hearing on Subchapter C
Taxation and Debt Management Subcommittee
Senate Finance Committee
September 30, 1985

This statement addresses the staff proposals dealing with special limitations on net operating loss and tax credit carryovers following a merger or other major change in control of a loss company. See Staff Proposal G at pp. 55-57 of the Senate Staff Report.

I am a lawyer in private tax practice in Washington. I am not appearing on behalf of any special interest or group. I was a member of the Joint Tax Committee staff in 1976 and, for better or worse, participated in developing the 1976 Act amendments to the loss carryover rules. I have been among a group of private practitioners who have devoted considerable time, inside the American Bar Tax Section and independently of the Section's work, toward developing new rules for net operating loss and credit carryovers after a loss company's stock ownership changes hands.

This particular subject has been called "the most hotly debated of the sore spots in the revenue laws." That description came from C. Rudolf Peterson, a member of an Advisory Group of tax practitioners who advised the Congress in 1958 on proposed corporate tax changes. My colleague, Nick Tomasulo, and I have "built" on the Advisory Group ideas and proposed a single unified rule for loss carryovers in an article in Tax Notes dated

September 12, 1983.[1] The ABA Tax Section adopts a "purchase price" rule similar in basic respects to our proposal, although differing on the issue of business assets (which Mr. Tomasulo discusses in his testimony).

A. Objection to Proposed Annual Limitation on Using Loss Carryovers

The Staff proposal for new limits on loss carryovers may be technically elegant, but it does not solve any real tax problem. We need to focus more clearly than the Senate Staff Report does on the objectives in this area. What are we worried about by limiting loss carryovers after a merger?

In the area of special limitations on net operating loss carryovers after a change in control of a loss company, the Staff Report wisely discards an earlier staff recommendation for two separate types of limitation: for taxable sales and purchases of stock, an annual "rate of return" limitation; and, for taxfree reorganizations, a "merger rule" limiting the use of losses to a percentage of combined earnings after the merger. The current staff recommendation switches to a single overall rule (which is good) and chooses, broadly, the "purchase" approach (also good).

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[1] Bacon and Tomasulo, "Net Operating Loss and Credit Carryovers: The Search for Corporate Identity," 20 Tax Notes 835 (Sept. 12, 1983).

The "purchase" approach treats all acquisitions as basically a form of purchase of one corporation by another for a price, regardless of whether that price is paid in cash, notes, stock, other forms of payment, or combinations of the foregoing. All of the leading approaches before us today reflect this one-rule concept for corporate acquisitions.

The differences among the leading approaches can be summarized as follows:

(1) Bacon-Tomasulo proposal.

Net operating loss carryovers should be limited, after a taxable or taxfree acquisition, to an amount equal to the value of the loss company at the date of acquisition. Such value is evidenced by the purchase price paid by the buyer. The allowed carryover amount would then be usable by the new owners without further limit on the amount of carryovers that could be absorbed in any one year.

(2) American Bar Association Tax Section.

Same as (1), except that use of the loss carryovers would be stretched over five years by allowing losses up to 24% of the purchase price in the first year, 48% by the end of the second year, 72% by the end of the third year, 96% by the end of the fourth year and 120% by the end of the fifth year.

(3) Senate Finance Committee Staff.

No reduction in the total amount of carryovers, but, in any one year after a change of control, the loss company could use only an amount equal to an interest-like return on the value of the company at the acquisition date. For this purpose, the Staff would use the long-term Treasury bill interest rate.

The Senate staff, in short, would not allow the new owner of a loss company to absorb carried-over losses as rapidly as he can use them. Instead, the staff would impose an annual -- and artificial -- limitation equal to a deemed investment return on the loss company's assets. For illustration the staff assumes a long-term Treasury bond interest rate of 12%. New owners could then use each year an amount of carryovers equal to 12% of the loss company's value at the date of the merger until the carryover years expire.

My belief is that if the Staff proposal is strengthened in certain other respects -- having to do with business versus investment assets and cash -- no annual limit on the buyer's use of carried-over losses is needed. The buyer should be allowed carryovers in an amount equal to the purchase price paid in the acquisition, and the company under its new owner(s) should thereafter be allowed to absorb losses up to that overall amount without any further annual limit on the dollar amount that can be absorbed in any one year after the merger.

B. The Defective "Neutrality Principle" Versus the Real Objective in Restricting Loss Carryovers

The major flaw in the annual limitation is that it flows from an unexamined premise in the Staff Report. That premise is described as a "neutrality principle," which the Staff takes to mean that a new owner should get no more annual use of carryovers than the loss company was theoretically likely to have used in any one year if no acquisition had occurred. This premise is not carefully examined in the Staff Report; it is instead assumed to be valid. The staff begs the question of whether the underlying premise is sound.

"Neutrality" does mean developing a rule that will neither encourage nor discourage an acquisition because of tax benefits. This neutrality can be fully achieved if the aggregate amount of carryovers surviving a major change in ownership is limited to offsetting the potential earning power of the loss company's income-earning assets at the date of the acquisition. That earning power is reflected automatically in the purchase price paid by the buyer (whether in the form of cash, stock, notes, etc.).

"Neutrality" does not mean imposing a limitation on the amount of carryovers which the new owner can use in any one year after the merger. We need only to prevent "trafficking." We do not need neutrality by saddling new owners with an investment return keyed to the old owners' business abilities. If we understand what purpose limitations on carryovers are intended to achieve, we will see that the staff proposal is merely an academic notion bearing no relation to any tax policy for limiting carryovers. We should not limit a buyer's annual freedom to absorb carryovers as rapidly as he can generate income to absorb them, in other words, unless we can point to a real need to do so. I think no such reason exists. This Staff proposal will not be truly neutral because it will discourage certain kinds of acquirers, as discussed more fully below.

Ordinarily, when one company acquires another, the new management can operate the old business or assets in whatever manner it chooses. If it earns more profit than the old owners earned, it pays higher taxes than the former owners paid. If the old business had been historically profitable and built up a large accumulated earnings and profits account, the new owners could draw out more money after the merger than the old owners might have done; the new owners would then receive fully taxable dividends at a faster rate than the old owners might have received. In other words, the tax law imposes no annual limit on the amount of taxable profits which the new owners may derive, or on the rate at which they draw down accumulated earnings and profits in the form of taxable dividends.

Should loss carryovers be treated differently? The tax law has never objected to the flow of loss carryovers across the lines of fusion in a corporate merger, so long as loss (and tax credit) carryovers are a normal incident to an acquisition of numerous favorable and unfavorable tax attributes of a business acquisition. A taxfree reorganization, for example, brings over the historic low basis of the transferor's assets as well as loss carryovers. The potental for abuse lies in the possibility that a new owner might acquire ownership of a company and obtain tax benefits from carryovers which greatly exceed the price he pays for those benefits. This is what "trafficking" in net operating losses means, and has historically meant.

The classic example of "trafficking" is a case where a buyer obtains losses for "ten cents on the dollar" -- meaning that he buys, say, a $1,000 loss for $100 and then uses that loss against $1,000 of his own income and saves $460 in taxes otherwise payable on that income. A $460 tax benefit, if successful, costs only $100!

We need an effective tax rule to prevent this kind of result, namely, a new owner obtaining tax benefits from loss carryovers which exceed the cost (purchase price) paid to obtain those benefits. Once we fashion a rule which achieves that goal, any annual limit on the buyer's ability to use the allowable carryovers is artificial and excessive. It is not needed.

C. Bacon-Tomasulo Proposal

An objective rule to prevent "trafficking" in losses is to allow the survival of carryovers up to (but no more than) the purchase price paid by the buyer, regardless of whether the consideration is paid in cash, notes, or stock.[2] This single rule should apply to all 50% or greater changes in control of a loss company, whether by means of taxfree reorganization, taxable purchase of the company's outstanding stock, transfer of money or property directly into a loss company in exchange for newly-issued stock, or redemption of a loss company's outstanding shares.

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[2] The purchase price in these cases is really a present value summation of the income which the buyer expects to obtain from the company's business assets in the future and the tax benefits he expects to obtain from the carryovers in the future.

The rule would work this way: If a buyer pays $500,000 for the stock of a loss company, that company (or its successor in a taxfree acquisition) could use only $500,000 of loss carryovers. Since the maximum tax saving from the carryover is 46% -- or $230,000 -- the buyer in that case must be paying $270,000 for other nontax assets of the company. He cannot profit by buying, principally to get tax benefits, a company having loss carryovers. Notice that so long as the corporate tax rate is less than 50 percent, the tax benefit from carryovers does not exceed 50% of the purchase price. The carryovers are necessarily incidental to a primary acquisition of nontax assets.

-- If the corporate income tax rate is lowered to 33% as President Reagan proposes, the foregoing result will be even more true. Each dollar ($1) of purchase price paid for a loss company would obtain only $1 of loss carryover which translates into 33 cents of tax savings. Who would make a tax-motivated purchase of a loss company if each $1 paid secures only 33 cents of tax benefits?

-- Indeed, "tax-motivated" mergers could not occur even if the corporate tax rate exceeded 50 percent. Suppose, for discussion's sake, the corporate tax rate goes up to 90%. Each $1 of purchase price would then obtain only $1 of carryover which produces 90 cents in tax savings on other income. An acquisition could still not be motivated by tax benefits because the buyer would be out of pocket economically more than the maximum tax savings we could get from the carryovers.

The loss company should be allowed to use carryovers (up to the purchase price ceiling) in whatever amount it can absorb by business operations after the transaction. No annual limitation is needed.3/ Indeed, once we reduce carryovers to their present value, it is absolutely essential to allow immediate use of that present value; otherwise, present value has no meaning.

The basic purchase price ceiling, as Bacon-Tomasulo propose it, assures that a buyer will pay primarily for business assets. That is what we want him to do to prevent abuse of favorable tax attributes and if new owners then bring in fresh blood and fresh ideas and turn a failing business around, there is no reason not to allow the inherited tax history from being used against whatever income can be generated. A 12% ceiling on using carryovers in any year assumes that a corporation is just a vehicle for making passive investments. It is not; it is a vehicle for running a business. Businesses have ups and downs, and we should not adopt a rule for the company's tax history that treats it as if it were a passive investment company.

3/ The ABA Tax Section proposal is second-best in this regard, stretching out the use of carryovers to no more than five years after the merger.

Eustice endorsement. Professor James S. Eustice, a leading corporate tax authority and co-author of the leading corporate tax treatise,[4] has expressed his view in favor of this idea of limiting carryovers to the acquisition price and then allowing the new owner to use losses as rapidly as he can create income to absorb them. He says that Bacon and Tomasulo argue, "persuasively to me at least, that this limitation would do enough of a job to effectively restrain whatever bad things are going on in this loss acquisition area."[5]

Further comments by Professor Eustice on our proposal are quoted at footnote 8 below.

Staff Reasons For Proposing Annual Limitation. Some Treasury and staff members have mentioned "policies" they believe justify an annual limitation. These ideas are, first, a company whose loss carryover is close to expiring unused would be encouraged to sell or merge with a profitable company which could use that carryover. More broadly, the absence of an annual limit would encourage mergers of loss companies at any time during their 15-year carryover cycle. A merger would occur any time a buyer comes along who can use losses faster than the seller might have used them.

4/ Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (Warren, Gorham & Lamont) (4th ed. 1979).

5/ Eustice, "Alternatives For Limiting Loss Carryovers," 22 San Diego L. Rev. 149, 153 (1985).

Second, the absence of an annual limitation would favor bigger over smaller buyers. That is, the Bacon-Tomasulo approach would favor acquirers who have large amounts of income and could soak up inherited carryovers faster than a smaller buyer might do. The tax law should not "exacerbate" this kind of "discrimination" in favor of larger acquirers.

Responses. Cutting loss carryovers down under a "purchase price" ceiling would mean that an acquirer will only obtain losses equal to the earnings prospects from the business assets which the loss company owns at the time of merger. A buyer could not obtain tax benefits from carryovers in excess of his economic cost to make the purchase. Those two factors mean that the acquisition of loss carryovers can never be more than incidental to a normal acquisition of business assets. The tax law should neither encourage nor discourage those kinds of normal acquisitions. That is the true meaning of a "neutrality principle."6/

6/ Elsewhere in the Senate Staff Report, the term "neutrality" is used in this sense. Thus:

> "Second, current law should be made more neutral, providing less influence over, and less interference with, general business dealings."

Senate Staff Report, p. 38. See also p. 70-71 of the Staff Report, where it is stated that loss carryover restrictions should provide neither an incentive nor a disincentive for changing control of a loss company.

An annual limit on the rate of using carryovers will, however, encourage the type of acquirers who have fairly stable and predictable income over a period of years. Such acquirers can absorb the carryovers under an annual limitation. Acquirers who have unpredictable or fluctuating levels of income, and who cannot predict from year to year how high or low their income is going to be, will be discouraged from making an acquisition. The Staff's narrow concept of neutrality, in other words, will not be neutral in operation.

If we do our job properly on the business v. investment aspects of the rule, we will assure that losses can be only incidental to an acquisition made primarily for business assets, and the allowed carryovers will be proportional to the earning power from those assets. A loss company can then ONLY be acquired for nontax reasons and we need not discourage a loss company from merging at any point during its loss carryover cycle. Seen in this light, a merger which must occur, if at all, for nontax reasons, cannot be said to "enhance" the value of carryovers that the old owners would not have used.

The tax law should not interfere with entrepreneurial changes in ownership of a business, including a loss company, and we should allow new owners free use of the tax history after a purchase so long as we assure in the first instance that the acquisition is primarily business-motivated. We should also not look less favorably on losses which are close to expiring than on carryovers having more years to run. There is no justification in the history of Section 172 for that kind of disfavor.

The question of whether big acquirers should obtain benefits over smaller acquirers is a fundamental question which underlies much of our economic society. We might consider limiting taxfree mergers to companies of comparable size and denying taxfree treatment where the acquirer is X times larger than the acquired company. Some suggestions along these lines have been made over the years by tax writers, but the Senate Staff declines to adopt any such distinction generally. Unless and until such a distinction is used in Subchapter C generally, we have no business creating a unique limitation under Section 382 blocking different kinds of buyers based on their size.

Professor James Eustice, in the article referred to in footnote 6, has agreed it is not necessary to impose any annual limitation once we cut the allowable carryovers down to the amount of the purchase price. Professor Eustice has expressed his view as follows:

> "The criticism of this [Bacon--Tomasulo] approach is that it allows the use, or consumption, of the loss carryovers more rapidly than some of the other reform

proposals, and hence is subject to what the congressional staffs feel is an excess of liberality. Despite the economic argument that one still wouldn't buy a loss business under this type of limitation solely for the tax benefits, some tax incentive for the acquisition may exist because of the accelerated timing benefits. In any event, the basic thrust of the Bacon-Tomasulo proposal is to eliminate the purely tax-motivated acquisition transaction, and even the dominantly tax-motivated transaction as well. In effect, only transactions involving an acquisition of a loss company for its business will be viable economically under this proposal. Basically, this is what all of the loss carryover limitations are about. Moreover, the Bacon-Tomasulo proposal is by far the simpler of any of the various reform regimes, both to comprehend and to apply in practice. Hence, on both those scores, I would vote for this one."7/

7/ Eustice, footnote 6, supra, at 153.

D. Business v. Cash or Investment Assets Inside the Loss Company; Sales of Business Assets After a Merger

Another weakness in the Senate Staff proposals revolves around the question of whether a loss company should be required to engage in some sort of generic business before and after an acquisition, or whether it is enough that a loss company owns merely cash (or cash-equivalent) assets, including passive investment assets. Many of my colleagues in this area tend to overlook the basic policy question of corporate identity: shouldn't a corporation be a vehicle for conducting a business, or can a mere corporate shell be a vehicle for transferring tax benefits through NOL carryovers?

My main concern is that cash and cash equivalents are fungible assets. They operate in effect to reimburse the buyer for part of the price he pays for the loss company. If the buyer is reimbursed, he is paying less for the loss company than otherwise appears. Under the purchase price rule, the carryovers should be allowed only in the amount of the economic, out-of-pocket cost to the buyer net of reimbursements.

Mr. Tomasulo and I suggest that the purchase price, for purposes of this rule, be reduced by cash and cash equivalents owned by the loss company at the date of sale. (An allowance for working capital should be made under this rule, but in an amount that could be limited to a stated percent of the purchase price).

The Staff Report comes at this same idea from a different direction, by proposing that the loss company must have at least 1/3 business assets at the date of sale. A planned sale of business assets of the loss company shortly after a merger would be dealt with by a "step transaction" rule (Report, p. 249). I think both these tests are too weak. Mr. Tomasulo addresses this business v. investment issue in separate testimony. I fully support his views.

The staff must choose between viewing cash and passive investments as reimbursements to the buyer which reduce his net cost, or as income-earning assets. I take the former view. A possible compromise lies in tainting cash, cash equivalents, and "personal holding company" assets, without trying to taint other semi-passive assets.

E. Other Issues

1. Role of Section 269.

I do not believe Section 269 is needed to backstop a purchase price limitation.

Section 269 allows the Service to deny loss carryovers where (1) a transaction literally escapes limitation under Section 382 but the Commissioner believes the parties intended mainly to buy and sell tax benefits; and (2) a transaction is not "caught" by specific terms of Section 382.

Where we think Section 269 should apply, it is in cases of "tax avoidance" -- which means that a buyer is trying to obtain tax benefits from carryovers which exceed his cost to get those benefits. Limiting carryovers to the purchase price prevents that very result automatically! Hence, Section 269 is not needed if a purchase price limitation is written into the statute.

What we might possibly need is not brain surgery on the parties' intentions but, arguably, a delegation of authority to the Treasury to bring under the purchase price limitation any transaction, or group of interrelated transactions, not covered by section 382, but which still have the effect of allowing a buyer to obtain tax benefits in excess of his cost to obtain the benefits. Section 305(c) contains a good example of this kind of delegation.

2. Consolidated Return Rules

A purchase price limitation will prevent abuse of loss carryovers by assuring that the tax benefit from loss carryovers can never exceed the buyer's cost to obtain them. Under present tax rates, if carryovers are limited to the purchase price, an acquisition of a loss company must be made primarily for nontax reasons.

The philosophy of a purchase price limitation does not depend on the type or volume of income which will absorb carryovers; it does not depend on which company's income absorbs the carryovers. The purchase price limitation automatically prevents "trafficking" as that term is defined here. Once that result is achieved, we need not be concerned with additional capital contributions by the new owner or by the buyer's using carryovers against income of a different company within an affiliated group of profitable companies.

Given those premises, I see no need to retain the Separate Return Limitation Year (SRLY) or Consolidated Return Change of Ownership (CRCO) limitations in the consolidated return regulations. The limitations basically limit the income against which carryovers can be used to the income of the loss company (rather than any other member of the affiliated group).

3. Supervisory Mergers of Savings and Loan Associations

The Senate Staff Report contains an exception for bankruptcy reorganizations (pp. 249-250).

An analogous group of transactions are FSLIC-supervised mergers of insolvent or defaulted savings and loan associations. Technically, these mergers occur under their own group of statutory provisions in the Home Owners' Loan Act, title 12 of the U.S. Code (rather than in the

Bankruptcy Code, title 11 of the U.S. Code). Existing law effectively excepts supervisory S&L mergers from carryover limitations (sec. 382(b)(7)(B)).

Given the Staff's exception for general bankruptcy cases, I suggest a parallel exception should be added for supervisory thrift mergers. These mergers are defined more specifically in Section 368(a)(3)(D)(ii) of existing law.

4. Bankruptcy Reorganizations

The Staff proposal needs major reworking in the area of bankruptcy reorganizations. The proposal exempts a bankruptcy reorganization, on one hand, but then goes to the other extreme and wipes out carryovers in toto if a second ownership change occurs within 2 years thereafter.

The exemption would evidently apply only to an internal-type restructuring where existing creditors and/or shareholders acquire control of a debtor company. The exemption would not apply if an outside party (or "angel" in bankruptcy jargon) acquires control of the bankrupt company in return for fresh capital. Presumably, the general rule would apply to the outside-acquirer situation, and if the loss company's value were zero immediately before the infusion of new capital under the plan, loss carryovers would be wiped completely away. Yet, it is arguable as a policy matter that bankruptcy cases (and perhaps certain defined workouts) deserve more special encouragement toward rehabilitation. The staff distinction is not desirable; it will create a host of enforcement difficulties, e.g. new investors buying existing creditors' claims in order to qualify under the proposed exemption for creditor takeovers.

If existing creditors accept stock in exchange for their claims in a bankruptcy case, they may try to find a buyer for their stock (and may have to, in some cases, where the creditor is a bank). The Staff proposal wipes out carryovers entirely if the creditor/shareholders sell during two years but not if they sell after two years. The basic issue is whether outside capital should be given an equal opportunity to rescue a troubled company, and, if so, whether NOL carryovers should survive a creditor takeover followed in fairly short order by an entry of outside rescue money.

One narrow alternative might be to exempt a bankruptcy reorganization and subsequent entry of new owners within a specified period if the debtor is insolvent at both points. This is a harsh approach, however, and may create serious definitional difficulties. Some broader relief can be developed, I suggest, while still preventing abuses.

CONCLUSION

An effective and complete way to prevent "trafficking" in tax losses is to limit a loss company, after a major change in stock ownership, to carryovers equal to the purchase price paid by the buyer. The buyer should then be allowed to use those carryovers without a further annual limitation.

Cash and cash-equivalent assets owned by a loss company at the date of sale should reduce the total amount of carryovers that survive the sale.

------END------

Senator **Chafee**. Now, Mr. Jacobs, the last two witnesses certainly differed from your views as far as investment companies go.

Mr. **Jacobs**. That is correct.

Senator **Chafee**. What do you say?

Mr. **Jacobs**. I believe we just disagree.

Senator **Chafee**. Well, I mean, this committee does worry about, as Mr. Tomasulo said, we don't want to see ads in the newspapers saying, "Come buy this corporation——"

Mr. **Tomasulo**. You will have a stock exchange.

Senator **Chafee**. Yes, there might be a market.

Mr. **Jacobs**. I think that what we are doing is taking this out of context. The ABA proposal has in it an antistuffing rule which would prevent you from putting those investment assets into the corporation within 2 years or in preparation for a sale at any time.

Second, you have the limitation on price, so that you may not pay $100,000 for a corporation that has $100,000 in investment assets in it, and then get $1 million, or $2 million or $10 million in net operating losses. The amount of losses that you can utilize are equal to the purchase price.

Senator **Chafee**. Oh, is that what Mr. Bacon suggests?

Mr. **Jacobs**. Well, it is there. It is there in the ABA formulation; it is there in the Green Book formulation. The only difference is that Mr. Tomasulo and Mr. Bacon would cut down the purchase price by the amount of the investment assets; they would disregard the presence of those investment assets in fixing the purchase price. Whereas, the ABA would disregard those assets, as would the Green Book, if those assets were infused either in anticipation of the change or within the proscribed 2-year period.

I don't think, as a practical matter, you are going to get anything that approximates safe harbor leasing or free trading of net operating losses. It would be a very rare case where that ad would appear, and I don't think it is going to happen.

Now, the other side of that coin, assuming that there is a risk there, and for these purposes I am willing to make that assumption, the problem appears that you don't know what an investment asset is. Is cash or a Treasury bill an investment asset? And the answer is clearly yes or clearly no, depending upon the circumstances. Working capital in an enterprise is not normally regarded as an "investment asset." And what about net leased property? What about a whole panoply of different kinds of assets used in various kinds of businesses which make it extremely difficult to define?

Once you introduce uncertainty into this process, then you introduce uncertainty into the bargaining process, and the sellers have an undue advantage over buyers. They will be buying the corporations cheap, and they will in turn be taking tax advantages at the cost of the Treasury. That is the result we should avoid.

Senator **Chafee**. You said the sellers would have an advantage over the buyers?

Mr. **Jacobs**. No; I'm sorry. The buyers would have an advantage over the seller. That is what they are doing today and that is what would continue.

Senator **Chafee**. Well, Mr. O'Connell says, "A plague on all of the proposals," and stick with what we've got.

Mr. O'CONNELL. I think that makes sense, because we have been dealing with the 54 Code rules, Mr. Chairman, for 30 years. I don't see any basis, if they had some value in limiting the traffic in net operating losses but permitting use of net operating losses at the same time, why they should be scrapped and an entirely new statute drafted into subchapter C, which is going to be every bit as complex as the existing rules.

The problems that we see with the staff proposals are that they are going to be overly generous—as one other witness pointed out—to the more financially sound loss corporations, and in that regard I think we may see some ads in the Wall Street Journal. And they are going to be inadequate to the smaller companies that are trying to turn themselves around through the infusion of new owners and new capital. And for that reason we think that in those situations the relief provided by this provision would be inadequate; whereas, the relief provided under the 54 Code rules would be much more adequate.

Also, we think that the Government is well positioned, despite comments to the contrary, to prevent trafficking in net operating losses in the situations of the case that was pointed out and in the example that Mr. Jacobs presented.

Senator CHAFEE. Mr. O'Connell, what about this general utilities doctrine? Everybody says when we are dealing with various preferences in the code that the preference will help capital investments, will help the creditors, will help widows keep their homes, or whatever it is. It seems to me the benefit from the general utilities only arises when a corporation is liquidated or acquired. Why should there be a preference for those activities?

Mr. O'CONNELL. Well, even though the liquidation of a corporation may only happen once in a number of years, certainly the sale of a business occurs all the time. In fact, a lot of people will invest in businesses with the expectation that they will be able to recapture their investment in some short period of time through a sale of that business. And investors now, if the general utilities is repealed, they are going to have to recognize that their investment is not going to be worth as much in the case of that eventual sale down the road. So it creates a bias, as other witnesses have pointed out, against incorporating the business.

And I think what we are going to see, as one other witness pointed out, is that there is going to be greater use of the S corporation rules, there is going to be greater use of keeping certain assets back, assets that will tend to appreciate and that don't require any recapture, out of the corporate solution and have them leased to the corporations. And that will be done solely for tax purposes. And again that would be contrary to the principle of neutrality.

Senator CHAFEE. Mr. Jacobs, we never heard you on the general utilities. Give me some thoughts on that.

Mr. JACOBS. I think I did speak to that earlier in my statement. I think that general utilities is obviously the key to the reform, and I would favor exoneration of long-term capital assets from its inclusion. I would use the staff mechanism but would think in terms, also, of reducing the rate from 28 to 20 percent, or whatever the maximum capital gain rate is.

Senator CHAFEE. Are there any other comments anyone would wish to make?

Mr. TOMASULO. May I say something?

Senator CHAFEE. You certainly may. What years were you staff here, Mr. Tomasulo?

Mr. TOMASULO. I was here from 1959 to 1973 on the joint committee staff. I was legislation counsel when I finished.

Senator CHAFEE. 1959 to 1973? That is quite a while.

Mr. TOMASULO. And then I went to teach at Wayne State University. Now, I am in practice here.

Senator CHAFEE. Yes.

Mr. TOMASULO. But I wanted to say, now, it is obvious that at the borderline there will be difficulty in distinguishing between an investment and a business. But I have no difficulty whatever in distinguishing between a hardware store and a share of United States Steel. In other words, 99 percent of the cases will be clear as a bell. That is the only point I wanted to make.

Senator CHAFEE. Mr. Hoffman.

Mr. HOFFMAN. Well, I am not so clear that you are going to have the hardware store and the shares of United States Steel to divide; I think you are going to have a problem in identifying that which has been working capital in an ongoing business from that which has not. It may turn out to be that working capital is temporarily parked in shares of United States Steel, but I don't think that necessarily is going to be the test.

I think that one of the misgivings about the overall changes may be that the changes are just another one of a series that is complicating the lives of every attorney, accountant, and businessman. Even the proposed NOL rules, which indeed, according to certain witnesses would clean them up, and I too think they would be made more readily understandable, add to the burdens. The fact is that the changes not only in the NOL context but in the Tax Code generally have been too rapid. The ability to cope, to learn the rules, to have court cases that come to conclusions interpreting the rules, to even have regulations out interpreting the rules, have not been possible what with the rapidity of legislation. And I think that almost everyone approaches legislation, even that which claims simplicity, as just another one of a series that has to be digested. And I believe that Professor Eustice said he feared being too young to retire, but too old to understand the rules. That bind is upon all of us, almost regardless of our age.

Senator CHAFEE. Well, thank you all for coming. This is a complicated area, and you all have been very, very helpful. And I think this audience has been excellant as well. I didn't know there were that many people interested in this area.

Thank you very much.

[Whereupon, at 12:51 p.m., the hearing was concluded.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

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October 10, 1985

Honorable Bob Packwood
United States Senate
Committee on Finance
Washington, D.C. 20510

Dear Senator Packwood:

These comments are submitted in response to Press Release No. 85-056 of the Senate Finance Committee, and with respect to a hearing on reform of corporate taxation held on September 30, 1985. While we have many clients who will be affected if the proposals set forth in the staff's report are implemented, this submission is not made on behalf of any client, but instead, represents our recommendations on these issues as an international accounting and consulting organization.

In general, we support the announced objective of the staff report. The rules governing corporate/shareholder relationships and the rules dealing with the acquisition of one corporation by another are in need of thorough review towards an ultimate goal of simplification and certainty. However, we would also like to point out that, while the present law in this area is complicated, relative certainty already exists because of the large number of cases, regulations and rulings that have been issued over the many years these rules have been in existence. In addition, we do not believe that the acquisition provisions of current law have been systematically abused. Rather, we believe that the current rules have operated rather efficiently since the fundamental principles were established almost 50 years ago.

Finally, due to the attention focused on President Reagan's tax reform plan, we do not believe that the general business community and many smaller tax practitioners are aware of the proposed changes to Subchapter C. These proposals should therefore receive wider exposure before the deliberative process is completed.

With that background, we will confine our comments to the issues set forth in the Committee's press release.

I. REPEAL OF THE "GENERAL UTILITIES" PROVISIONS

We strongly disagree with the staff's recommendation to repeal the General Utilities provisions, especially in the context of taxable corporate acquisitions and liquidations (i.e., Sections 336, 337 and 338).

Obviously, the staff's proposal amounts to a major expansion of the system of double taxation, and seems to run contrary to the recent trend that has focused on reducing the impact of double taxation on corporate earnings. In President Reagan's Tax Proposals to the Congress for Fairness, Growth and Simplicity, for example, it is stated that double taxation of corporate earnings "increases the cost of capital for corporations and discourages capital-intensive means of production in the corporate sector. Similarly, double taxation discriminates against goods and services that are more readily produced by the corporate sector as well as activities customarily engaged in by corporations." See President's Tax Proposals, Chapter 6.02. Specifically, this proposal amounts to an expansion of the taxation of capital gains from 20% to 42.4% if the corporate form is used. For example, under current law, if a corporation holds an undeveloped piece of real estate, adopts a plan of complete liquidation, sells the undeveloped real estate (i.e., raw land) and distributes the sales proceeds to its shareholder, only a shareholder level capital gain tax, with a maximum rate of 20%, will be incurred. We believe that this approach is entirely appropriate, because the tax incurred in this situation is exactly the same as it would be had the owner of the company not held the real estate in corporate form. On the other hand, if the staff's proposals are enacted, the tax liability incurred in this situation would be 42.4% of the proceeds realized on the sale. For example, assume that there is a $100,000 gain on the sale of the land. First, the corporation would incur a $28,000 tax liability on the sale, leaving $72,000 to be distributed to the shareholder. The shareholder would incur a $14,400 tax on the liquidation, for a total tax liability of $42,400 or 42.4%.

We do not believe that this result is justified. That is, it provides a much greater tax liability than would have been incurred had the corporate form not been chosen by the owner of the real estate, and thus provides a substantial economic disincentive to the use of the corporate form. In addition, given the strict statutory restrictions that limit the availability of S corporation status, we believe that even many closely held entities will not be able to escape the tax increase associated with the staff proposal.

The practical impact of this proposal, if enacted, would be to eliminate taxable acquisitions in which the acquiring corporation receives a basis stepup on the assets of the target corporation to reflect the purchase price (i.e., the purchaser's economic investment). This is because no purchaser in this situation will choose to make a basis stepup unless the incremental tax benefits received, considering the period in which such benefits will flow through the acquiring company's tax return, on a present value basis, is greater than the up-front tax liability incurred in a taxable acquisition. Set forth in Exhibit I are examples of three types of property that would typically be acquired in a corporate acquisition. As can be seen, the only time it would be prudent to do a basis stepup would be where the target corporation's assets were entirely nonordinary income or recapture assets, and where the acquiring corporation would be able to claim a five-year life for ACRS depreciation purposes.

It would be rare to envision a target company that would hold only this type of asset. Thus, while the proposals purport to provide an election to step up the basis of the acquired corporation's assets in the case of any qualified acquisition, it would almost never be to the benefit of an acquiring corporation to make this election. Therefore, these companies would not be able to recover for tax purposes the real cash cost of the acquisitions.

To support this proposition further, another example of the effect of the proposed rule is set forth below:

> Suppose that Individual A formed Corporation X 30 years ago, and Individual A owns all of the stock of Corporation X, having a $100,000 basis in such stock. Individual A wishes to retire and does not have any family members to whom he will turn over the business. Accordingly, Individual A wishes to sell Corporation X to an unrelated corporation, Corporation Y. Y is willing to acquire the assets of X for $8,000,000. Therefore, it is proposed that Corporation X will sell its assets to Y for cash and will then completely liquidate. Assume X has an effective tax rate of 46%. X holds the following assets:
>
> 1. Inventory--LIFO basis $500,000; current FIFO cost $1,000,000; FMV $2,000,000.
> 2. Land--Basis $1,000,000; FMV $3,000,000.
> 3. Machinery--Basis $1,250,000; original cost $2,500,000; FMV $3,000,000.

Current Law Result (Assume Sec. 337 Applies)

LIFO recapture (($1,000,000 FIFO cost - $500,000 LIFO basis) x 46%)	$ 230,000
Depreciation recapture (($2,500,000 original cost - $1,250,000 basis) x 46%)	575,000
Tax liability incurred by Corporation X	$ 805,000
A's tax liability (($8,000,000 - $805,000-100,000 x 20%)	$1,419,000
Total tax liability	$2,224,000
After-tax cash	$5,776,000

Proposed Law Result

Gain on inventory (($2,000,000 - $500,000 x 46%)	$ 690,000
Gain on land (($3,000,000 - $1,000,000 28%)	560,000
Gain on machinery:	
Depreciation recapture (as above)	575,000
Remaining gain ($3,000,000 - $2,500,000) x 28%)	140,000
Tax liability incurred by Corporation X	$1,965,000
A's tax liability (($8,000,000 - 1,965,000 - 100,000) x 20%)	$1,187,000
Total tax liability	$3,152,000
After-tax cash	$4,848,000

As can be seen, the proposed change would dramatically increase the tax liability incurred by Corporation X, and would correspondingly decrease the after-tax proceeds received by A on the sale of the closely held business.

Finally, in our view, mergers and acquisitions in general, and stepup acquisitions in particular, are not inherently "bad." Indeed, such transactions typically involve the free flow of capital to efficient uses and create more positive business results through the effects of business synergism. These transactions also allow growing companies to avoid costly start-up efforts. In many situations, mergers and acquisitions allow family companies to be acquired, thus fulfilling the financial and business desires of these parties. Thus, we believe that the tax rules in this area should be "neutral" and should constitute neither an economic incentive nor disincentive to such transactions.

It is interesting to note that in connection with proposed legislation to curb oil company mergers in April 1984, Assistant Secretary of Tax Policy, Ronald Pearlman observed that it was doubtful that such transactions are primarily tax motivated. Moreover, the significant recapture costs currently associated with Section 337 and 338 stepup acquisitions already provide a major tax disincentive to such transactions. Indeed, since the enactment of Section 338 in 1982, we have witnessed a steady decline in the number of acquisitions for which step-up treatment is elected

Accordingly, set forth below is a summary of the economic results that we believe would occur if the staff's proposals in the liquidation area were enacted:

1. Adverse Impact on Target Companies. Because, as set forth in the examples above, an acquiring corporation will not, for practical purposes, be able to obtain tax basis in the acquired corporation's assets equal to the economic cost of its investment, we believe that acquiring corporations will be willing to pay less to acquire target corporations. For example, if an acquiring corporation wishes to obtain a 10% after-tax return on its investment, the tax benefits associated with current law allow it to make a relatively larger payment for the target corporation than the proposed new rules would permit. Therefore, the effect of this proposal (which we believe was not intended) will be to diminish underlying stock values of target corporations. This seems a harsh penalty for small businesses or closely-held entities. This economic distortion is further exacerbated by the fact that many of the gains involved are not true economic gains. Rather, they are gains largely attributable to inflation. Simply put, we believe that it is fundamentally unfair to further tax the inflationary gains of corporations at higher

rates than would have occurred had the business been conducted as a sole proprietorship or as a partnership.

2. Enactment of the Proposals would Provide a Further Disincentive to the Use of the Corporate Form. As illustrated above, enactment of the staff's proposals would result in a higher overall effective tax rate than if the business had not been incorporated. Simply stated, competent tax professionals will advise clients that the use of a regular corporation to conduct business operations will significantly diminish the owner's after-tax value of the business when compared to the use of other forms of ownership such as partnerships or S corporations. Since nontax considerations encourage and in many cases mandate the use of the corporate form, it seems unsound policy to further discourage the use of this business entity by imposing a further double tax.

3. The Proposals Would Favor Publicly Held Corporations. We also believe that the proposed changes will create a bias for publicly held corporations to acquire target corporations, and diminish the opportunity for privately held corporations to make similar acquisitions. The new proposals would encourage acquisitions

using stock of an acquiring corporation. Obviously, the shareholders of the target corporation would prefer to take stock in a publicly held acquiring corporation that can later be sold on established securities exchanges, rather than accept stock of a privately held corporation, that, in many instances, is not readily marketable.

4. The Proposals Would Hurt the Ability of American Business to Compete in the World Market. Since the proposals would expand the system of double taxation, it would provide owners of acquired businesses with less after-tax capital to reinvest in income producing activities. The staff proposals create a system in which distribution of all corporate ordinary income assets is taxed at a maximum rate of 73% ((1.00 x 46%) + (.54 x 50%) = 73%), in which taxation of corporate capital assets sold in the termination of a business are taxed at a rate of 42.4% ((1.00 x 28%) + (.72 x 20%) = 42.4%), and ordinary income assets sold are taxed at 56.8% ((1.00 x 46%) + (.54 x 20%) = 56.8%). It can readily be argued that on a comparative basis this heavy tax burden on income puts American businesses at a substantial economic disadvantage when competing in world markets with corporations formed in

other developed countries that have a lower effective tax rate on corporate earnings.

II. SHAREHOLDER RELIEF PROVISIONS

The staff report proposes two kinds of relief from a repeal of General Utilities. The first provision would basically extend the substituted basis provisions of Section 333 to any electing shareholder, and repeal the one-month liquidation and dividend rules. Practically speaking, this provision only provides relief in the context of a closely held corporation when the shareholders intend to continue the business in noncorporate form, a situation which will rarely arise. In the vast majority of cases, both closely held and public corporations are liquidated as part of the disposition of the corporation's business. Obviously, Section 333-type relief in this situation is no relief at all. If the assets are sold by the corporation, the corporation will be taxed on the sale and the shareholders will pay a second tax on the distribution of the proceeds; if the asset sale takes place at the shareholder level, the corporation will be taxed when it liquidates and the shareholders (assuming they have made a Section 333-type election) will again be taxed on the subsequent sale of the distributed assets.

The second relief provision will permit shareholders of "small business corporations" to increase the basis of their stock to reflect corporate level gain incurred in acquisitions or liquidations with respect to long-held capital assets. Small business corporation is defined as one whose fair market value does not exceed $1 million. The basis adjustment would be reduced on a ratable basis to the extent that the value of a corporation exceeds $1 million, with no adjustments at all if the value exceeds $2 million.

Again, we believe that this provision would provide grossly inadequate relief. The great majority of corporate acquisitions and liquidations would remain subject to tax at both the corporate and shareholder levels and the fundamental objections to the repeal of General Utilities, as discussed above, would remain unredressed.

Taken as a whole, the reform provisions consist of two elements: simplification, which we support, and a substantial additional tax on the disposition of corporate businesses, which we feel is not supportable. If the repeal of General Utilities is necessary in order to separate shareholder level tax consequences from corporate level elections, and provide a uniform definitional structure for corporate acquisitions, we believe that a full shareholder credit should be provided. Under this "revenue neutral" approach, we believe the reform element of the proposal would gain widespread support and acceptance.

III. MAKING CORPORATE LEVEL TAX CONSEQUENCES OF QUALIFIED ACQUISITIONS EXPLICITLY ELECTIVE

Under this proposal, corporations making qualified acquisitions may elect either cost basis or carryover basis treatment. The tax consequences to the acquired corporation will result directly from this corporate level election, with no gain or loss recognized in a carryover basis transaction and full corporate level gain or loss resulting from a cost basis transaction.

As discussed previously, we believe that the repeal of General Utilities is too high a price to pay for the apparent simplicity offered by this proposal. In addition, the interplay between the carryover basis provisions and the repeal of General Utilities will place purchasing corporations in an untenable position: a cost basis election will virtually always be uneconomic, since the present value of the tax benefits to be derived from a stepped-up asset basis will rarely, if ever, exceed the up-front tax liability that the election would entail; alternatively, as discussed below, purchasers will invariably face the prospect of losing a substantial portion of their investment if carryover basis treatment is selected.

Basis in Stock of Controlled Subsidiary

Under this proposal, when control of a corporation is acquired in a qualified acquisition and a cost basis election is not made, the acquiring corporation's basis in the stock of the acquired corporation will be equal to the acquired corporation's net asset basis.

For example, assume that corporation T has assets with a net basis of $80 million and a fair market value of $100 million. If corporation P purchases the T stock for $100 million and does not make a cost basis election, its basis in the stock of T will be $80 million (under current law, of course, P would have a $100 million basis in T, reflecting the purchase price for the T stock).

To avoid the obvious unfairness of this result, a "premium account" would reflect the $20 million excess of purchase price over basis. The amount in the premium account would be added to the stock basis, so that the total stock basis would initially equal the purchase price for the stock, $100 million.

Similarly, if P had purchased the T stock for $60 million, P's basis in the T stock would again be the basis of T's assets, $80 million, and a "discount account" would reflect the $20 million difference between purchase price and stock basis. In this instance, the discount account would initially reduce P's stock basis in T to $60 million.

The proposal thus far appears deceptively simple and fair. Further examination of the operating rules, however, leads to the conclusion that it is neither.

First, the premium and discount accounts are to be maintained for only three years under the current proposal; at the expiration of that period the accounts will simply disappear, terminating any equalizing effect they might have provided between purchase price and asset basis.

We believe that the proposed three-year period is arbitrary and inadequate. The only way for a purchaser which has paid a "premium" over asset basis (a situation likely to arise in virtually every acquisition) to recover its initial investment under this proposal would be for it to sell the acquired company within three years. If, as will frequently be the case, the purchaser does not choose to sell during that period, the portion of its investment represented by the premium will, in effect, be lost for tax purposes. A subsequent sale of the acquired company would therefore be more likely to produce an economic loss, but a taxable gain. Accordingly, we believe that the premium and discount accounts should be maintained permanently. This would provide purchasers with a more reasonable opportunity to recover their investments and produce fairer and more equitable treatment in the majority of cases. Moreover, in view of the fact that asset basis must be regularly computed in the context of corporate income tax return preparation, we do not feel that maintenance of the accounts over a longer period will impose an undue recordkeeping burden.

its net asset basis, P's stock basis would be increased by $10 million. In other words, the two adjustments would cancel each other out. If P were to now sell the T stock for $110 million, it would recognize a $10 million gain. In effect, T's income will have been taxed twice, once at the T level (or as part of a consolidated return filed by P) and again on the sale of T's stock.

Under current law, this inequitable result is avoided by the investment adjustments prescribed in the consolidated return regulations, which generally provide for an increase in P's stock basis in T equal to T's undistributed earnings. In its summary of this proposal, however, the Senate Finance Committee staff states that the "complex, continuing adjustments to the stock basis, such as those contained in the consolidated return regulations, are not required." Apparently, it was envisioned that adjusting the stock basis to reflect changes in net asset basis would make the consolidated investment adjustments unnecessary. As indicated in the foregoing example, however, the required adjustments to the premium and discount accounts will necessitate continued investment adjustments in order to prevent T's earnings from being subjected to a double tax.

It is also unclear how replacing the consolidated investment adjustments with adjustments tied to changes in net asset basis will promote simplicity. Earnings and profits, one of the key elements of the investment adjustment process, will

Adjustments to Premium and Discount Accounts

Under the present proposal, even the minimal relief provided during the three-year period would be illusory. As discussed below, continuing adjustments to the controlling corporation's stock basis, corresponding to changes in the subsidiary's net asset basis, are apparently intended to replace the investment adjustments currently prescribed by the consolidated return regulations. However, these adjustments will be negated by offsetting adjustments which must be made to the premium and discount accounts. Specifically, the subsidiary's earnings during the three-year period would reduce the balance in the premium account (or increase the balance in the discount account), resulting in a corresponding reduction in stock basis. The net effect of the required adjustments will be a potential double tax on the subsidiary's earnings.

This may be illustrated by assuming, as in the foregoing example, that P purchases T stock for $100 million and that T's net asset basis at the date of acquisition is $80 million. P's initial stock basis in T would be $80 million with a $20 million premium account. If P were to immediately sell the stock of T, it would therefore not recognize any gain or loss--an appropriate result. Now suppose that at the end of Year 1, T has earned $10 million. Two adjustments would be required: first, its premium account would be reduced by $10 million; second, assuming that T's earnings resulted in a $10 million increase in have to be computed in any event in order to determine whether a corporate distribution constitutes a dividend. Adjustments will also have to be made, as under current law, to reflect the extent to which net operating losses are utilized in a consolidated return. For example, if T has a current loss, the loss will result in a reduction in net asset basis under the proposal and a corresponding reduction in P's stock basis in T. If the loss is not utilized in the current year, however, and cannot be carried back to a consolidated prior year, T will have suffered a reduced basis without having realized any benefit from the loss. It is for this reason that an unutilized loss results in a positive stock basis adjustment under the current consolidated return regulations; elimination of this adjustment in the name of simplicity would be unfair.

Basis of Assets Acquired in Carryover Basis Transactions

If assets, rather than stock, are acquired in a carryover basis transaction, many of the inequities described above will likewise be present. For example, if P purchases substantially all of T's assets for $100 million, and the acquired assets have a tax basis of only $80 million, P's basis in the assets will be $80 million (assuming that a cost basis election is not made). Obviously, P will immediately lose tax basis for $20 million of its investment in this case.

One possible solution to the unfairness of this result would be to adopt an approach similar to the one described in the recently published Section 338 regulations. When assets are acquired from a target corporation which is not a member of the purchaser's affiliated group, and the target is subject to a protective carryover election (i.e., a Section 338 election is not made and the purchaser specifically elects carryover basis treatment with respect to any "tainted asset acquisitions"), the purchaser may transfer the acquired assets to a subsidiary and receive a basis in the subsidiary's stock equal to what its basis would have been absent the carryover election. Similarly, in the foregoing example, P could be given the option of transferring the acquired T assets to a subsidiary within a prescribed period and receiving a basis in the subsidiary's stock of $100 million, rather than $80 million. Alternatively, P's basis might remain at $80 million, but a premium account could be created to reflect the $20 million excess of purchase price over carryover basis. This would effectively mirror the results under the proposal in the case of qualified stock acquisitions, thus providing similar treatment in functionally equivalent transactions.

IV. A. SEPARATING SHAREHOLDER LEVEL TAX CONSEQUENCES FROM CORPORATE LEVEL ELECTIONS AND FROM THE TAX CONSEQUENCES TO OTHER SHAREHOLDERS

B. UNIFORM DEFINITIONAL STRUCTURE FOR QUALIFIED ACQUISITIONS

The proposals relating to the separation of corporate/shareholder tax consequences and the definitional aspects of acquisitive transactions are, we believe, the heart of the reform provisions in Subchapter C. Enactment of these provisions would provide simplicity, clarity and coherence to an area which to many observers is marked by seemingly arbitrary distinctions where form reigns supreme.

Nevertheless, we do not support the proposed revisions to the extent they are dependent on the repeal of General Utilities. As discussed previously, however, if the structural simplicity and uniformity embodied in the proposals were combined with a full shareholder credit, we would support these aspects of the proposals.

V. NET OPERATING LOSS CARRYOVERS

This proposal would provide a single rule limiting the availability of net operating loss carryovers and other carryforwards following a change in the equity ownership of a corporation of more than 50%. Under the proposal, the availability of such carryovers would be limited to an amount equal to the federal long-term rate under Section 1274(d) times the value of the corporation at the time of the change in ownership. We have four general comments regarding this proposal.

First, by tying the utilization of net operating loss carryovers and other carryforwards to the applicable federal long-term rate, a rate which is subject to adjustment every six months, purchasers will be unable to predict with any degree of accuracy the extent to which such carryovers may be utilized. For a corporation which has suffered a period of reversals, a net operating loss carryover may constitute one of its most valuable assets, representing perhaps the last opportunity for shareholders to recover their investments. Accordingly, the inability to ascertain the potential utilization of these attributes following an acquisition is likely to adversely affect the purchase price received by shareholders of loss corporations.

Secondly, the utilization of the federal long term rate as the yardstick for measuring an ideal rate of return on a loss corporation's assets, penalizes corporations whose actual operations yield a higher rate of return (while theoretically affording a windfall to less profitable corporations, other limitations, such as the SRLY rules, would restrict the utilization of loss carryovers in such cases). We believe that a more equitable approach would be to utilize the higher of actual return on operations or an appropriate objective rate of return.

Third, since the utilization of net operating losses following an acquisition would be limited by the value of the acquired business, purchasers will not receive a benefit for any purchase premium, that is, for amounts paid in excess of fair market value. Such premiums are a commonplace occurrence, since it is frequently difficult to value an acquired business until after the acquisition has been consummated. If the limitation formula is to be based upon criteria such as value, it would be appropriate in our view to utilize purchase price as the relevant factor, thus affording recognition to the purchaser's actual investment.

Finally, we believe that some provision should be made to reflect any continuing participation in the loss corporation by its former shareholders. Current law Section 382(b), effectively limits the utilization of net operating loss carryovers and other carryforwards on a sliding scale, which corresponds to the continuing ownership of the acquired corporation's shareholders in the acquiring entity. We believe that this approach is equitable, since it acknowledges the investment heretofore made by such shareholders in the loss corporation. Similar allowances should be made in the proposed revisions.

* * * * * * *

The foregoing comments were prepared by Earl Brown, 33 West Monroe Street, Chicago, Illinois 60603, 312-580-0033. Questions should be addressed to him as appropriate.

Very truly yours,

ARTHUR ANDERSEN & CO.

By Earl C Brown
Earl C. Brown

MEC

EXHIBIT 1

Type of Property With Respect to Seller	Type of Property With Respect to Buyer[1]	Gain Recognized By Seller	Tax Liability to Achieve Stepup[2]	Depreciation Benefits to Buyer[3] (Present Value; 12% Discount)	Present Value of Net Tax Benefit (Detriment)
Capital Asset	5 year ACRS	$100,000	$(28,000)	$34,820	$ 6,820
Capital Asset	15 year ACRS	$100,000	$(28,000)	$23,320	$ (4,680)
Asset Subject to Depreciation Recapture, or Otherwise, to Ordinary Income	5 year ACRS	$100,000	$(46,000)	$34,820	$(11,180)
Ordinary Income Asset	Buyer receives 50% Benefit of Basis Step up - For Each of 2 Years After Acquisition	$100,000	$(46,000)	$40,895	$ (5,105)

ootnotes:

1. Assumes no benefit to buyer for ITC, because of the limitation for used property. Contained in IRC Sec. 48(c)(2).
2. Assumes capital gains are taxed at a 28% rate, and recapture or ordinary income is taxed at a 46% rate.
3. Assumes buyer's tax rate is 46%.

LTR/SUB0357F/MEC

A

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of Insolvency
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Monday, September 30, 1985

The Honorable Senator John Chaffee
(R-Rhode Island)
Chairman, Subcommittee on Taxation
and Debt Management
Committee on Finance
U.S. Senate

Written Testimony of the Association of Insolvency Accountants at the Public Hearing on the Staff Recommendations to Revise Subchapter C of the Internal Revenue Code

Introduction

I am pleased to provide you with the views of the Association of Insolvency Accountants regarding the Staff recommendations to revise subchapter C of the Internal Revenue Code (hereinafter the "Staff Recommendations").

The Association of Insolvency Accountants is a national organization of insolvency practitioners involved extensively in the rendering of tax, financial and operational advice to entities undergoing financial

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rehabilitation. Our members include representatives of international firms and local practitioners with recognized expertise in this field.

My name is Kenneth J. Malek. I am a tax partner with Seidman & Seidman, CPAs, where I head up the tax function within my firm's National Bankruptcy Group.

The commentary I am presenting on behalf of the Association of Insolvency Accountants is limited to those aspects of the Staff Recommendations specifically addressing limitations on corporate net operating loss carryovers following changes in ownership..

Summary of Testimony

(1) The factors to be considered in drafting legislation on net operating loss carryovers can be grouped into two major areas: economic policy considerations and tax policy considerations. Given the high rate of U.S. business failures during recent years, we believe that the economic policy considerations should be given priority emphasis.

(2) Bankrupt, insolvent and other financially distressed companies typically generate significant net operating losses and other favorable tax attribute carryovers. The retention of this tax history following a change in ownership is essential to attract fresh equity capital required for rehabilitating these continuing businesses.

(3) Under the approach taken in the Staff Recommendations, utilization of net operating loss carryovers following a 50 percentage point or more shift in equity ownership would be limited to a specified rate of return multiplied by the equity value of the loss corporation at the time of the ownership shift. The concept underlying this limitation often is referred to as the "neutrality principle".

(4) Because the equity value of bankrupt, insolvent or other financially distressed corporations typically is de minimis, the approach taken in the Staff Recommendations virtually would eliminate the loss corporation's tax carryovers following a new capital infusion.

(5) Contrary to the comment at page 34 of the Staff Report, we believe that present law contains a business-continuity test for both taxable purchases and nontaxable reorganizations. These business-continuity tests promote the valid policy

objective of allowing the new owners of a loss corporation to reap the benefits of the loss carryovers only if they rehabilitate and continue the loss corporation's business.

(6) Based on the foregoing, we urge your Subcommittee to abandon the approach based on the neutrality principle and retain the general approach of present law §§382, 269 and the consolidated return regulations.

(7) The Staff Recommendations contain an exemption for loss corporations involved in Title 11 bankruptcy cases and similar judicial proceedings. If the general approach of the Staff Recommendations is adopted as proposed legislation, we strongly urge:

(a) That the exemption be expanded to include all financially distressed corporations, to avoid otherwise-unnecessary chapter 11 filings; and

(b) That the two-year restriction on subsequent changes in ownership be eliminated, so as not to impair the loss corporation's ability to attract new capital essential to the rehabilitation of its business.

(8) Finally, the Staff Recommendations contain a rule providing for disallowance of deductions for interest paid during a three-year period, with respect to debt that is exchanged

for stock in a title 11 or similar proceeding. The reason advanced for this provision is that the debt exchanged for stock would have constituted equity at the time interest would have been paid. We believe that the mere fact that interest is paid in cash during a period of financial difficulty is a conclusive indication that the related debt obligation is in fact debt and not equity. For this and other reasons, we recommend that your Subcommittee not adopt the three-year rule for disallowance of interest deductions.

Factors to Be Considered in Drafting Legislation on Net Operating Loss Carryovers -- Economic Policy Considerations versus Tax Policy Considerations

Business bankruptcies and insolvencies reached record levels during the last three years. Based on data from the Report of the President (February, 1985), approximately 87 in every 10,000 businesses failed annually during the period January, 1981 through December, 1983. This represents a failure rate higher than anything this country has seen since the great depression.

The number of employees and total principal amount of outstanding debt in currently pending and recently settled chapter 11 cases is astronomical, and business failures are by no means limited to small or start-up phase companies. Recent chapter 11 filings have included such well-known organizations as AM International, Inc., Continental Airlines Corporation, Saxon Industries, Inc., Wickes Companies, Inc., and a number of others. The number of employees and total debt involved in just these four cases illustrates the magnitude of this problem:

Debtor Corporation	Total Number of Employees*	Liabilities Subject to Settlement Under Chapter 11*
AM International, Inc.	10,475	$284,112,000
Continental Airlines Corp.	10,000	661,250,000
Saxon Industries, Inc.	2,050	320,109,000
Wickes Companies, Inc.	13,550	613,890,000
	36,075	$1,879,361,000

*Source: Most recently published financial statements

Given this dire economic condition, an important policy goal of our country should be the rehabilitation of distressed businesses, to preserve jobs in the local communities and foster increased competition in the marketplace. The liquidation of these businesses not only would result in a severe loss in payroll tax revenues, but also would increase significantly payments to former employees under welfare and related programs and could result in nonpayment of priority, pre-petition taxes.

The factors to be considered in drafting legislation on net operating loss carryovers can be grouped into two major areas:

(1) Economic policy considerations, for rehabilitating financially distressed businesses that may have generated substantial loss carryovers; and

(2) Tax policy considerations, for restricting abusive utilization of net operating loss carryovers.

With the present high rate of business failures, we believe it is essential that the economic policy considerations (described above) be given primary emphasis in drafting legislation in the net operating loss area; that is, a loss corporation should not be stripped of its tax history merely because it requires new capital to rehabilitate its business. In fact, the tax laws should be designed to enhance the ability of loss corporations to attract new capital, subject to the new owners rehabilitating and continuing the loss corporation's historic business activities.

Financially Distressed Companies Need to Attract Fresh Capital

In the typical bankruptcy situation, the financially troubled corporation requires a significant capital infusion:

(1) To bring current its long-term debt obligations;

(2) To provide a percentage cash payout to unsecured creditors; and

(3) To provide working capital for rehabilitating its business operations.

As bankruptcy practitioners, we have found that the mere scale-down of debts and deferral of payment is insufficient in most instances to effect the successful rehabilitation of the distressed company, because the capital provided by this debt already has been expended in the failing enterprise. Rather, what the debtor truly needs is an infusion of fresh capital, the only source for which often is an outside equity investor.

However, investment in a troubled company by nature is highly speculative, and the outside investor will be unwilling to invest unless he can project a significant profit upon successful rehabilitation of the company. The net operating loss carryovers provide a significant enhancement to the outside investor's profit projection, and hence are an essential ingredient enabling the troubled company to attract capital for the rehabilitation of its business.

Summary of the Staff Recommendations

Under the approach taken in the Staff Recommendations, utilization of net operating loss carryovers following a 50 percentage point or more shift in equity ownership would be limited to an amount equal to the federal long-term rate under §1274(d) of the Internal Revenue Code, multiplied by the equity value of the loss corporation at the time of the ownership shift. The concept underlying this limitation often is referred to as the "neutrality principle".

Impact of the Staff's Recommended Net Operating Loss Limitations on Financially Distressed Corporations

In the case of bankrupt, insolvent or other financially distressed corporations, effectively all hard asset value is offset by debt left in place after financial restructuring. This results in a very low value for their equity prior to the new capital infusions needed for rehabilitation. Consequently, under the approach taken in the Staff Recommendations, a new capital infusion would virtually eliminate the loss corporation's tax carryovers.

Present Law Promotes Rehabilitation of Financially Distressed Businesses by Requiring Continuation of the Business

We believe that the business-continuity tests of present-law generally promote the valid economic policy objective of allowing new owners of a loss corporation to reap the benefits of the loss carryovers only if they rehabilitate and continue the loss corporation's business.

Contrary to the comment at page 34 of the Staff Report, we believe that present law contains a business-continuity test for both (1) taxable purchases and redemptions of stock described in §382(a)(1)(B) (hereinafter "taxable changes in ownership"), and (2) certain nontaxable reorganizations specified in §382(b)(1) (hereinafter "tax-free changes in ownership"). The business-continuity test for taxable changes in ownership is prescribed by Treasury regulation §1.382(a)-1(h). Under the regulation, "all the [relevant] facts and circumstances of [a] particular case [are] taken into account. Among the relevant factors . . . are changes in the corporation's employees, plant, equipment, product, location, customers, and other items which are significant in determing whether there is, or is not, a continuity of the same business enterprise."

The business-continuity test for tax-free changes in ownership is prescribed by Treasury regulation §1.368-1(d). However, these rules are less stringent and less detailed than the rules for taxable changes in ownership. For tax-free changes in ownership, the acquiring corporation must either (1) "continue the acquired corporation's . . . business" or (2) employ "a significant portion of the [acquired corporation's] business assets in a business. [Emphasis added]." If the acquired corporation "has more than one line of business, continuity of business enterprise requires only that [the acquiring corporation] continue a significant line of business." If the loss corporation is the acquiring corporation in a transaction constituting a tax-free change in ownership, there is no requirement that the historic business of the loss corporation be continued.

For this reason, we recommend that you expand the business-continuity test for taxable changes in ownership (as prescribed by Treasury regulation §1.382(a)-1(h)) to all other changes in ownership involving a change in control of the loss corporation of 50 percentage points or more. In the case of tax-free changes in ownership, the business-continuity test should apply to any corporate party to the reorganization having a loss carryover and experiencing a 50 percentage point or more change in control. We believe that this expansion would eliminate the abuses possible under present law, such as transactions structured under the Maxwell Hardware Co. case,[1] §351 transactions, etc.

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[1] Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir., 1965).

This expansion of the business-continuity test would achieve both the economic policy objectives and the tax policy objectives of legislation on net operating loss carryovers. By requiring continuation of the business which produced the losses, the expanded test would promote the rehabilitation of distressed businesses and would prevent the sale of losses by shell corporations.

Recommended Abandonment of Neutrality Principle

Based on the foregoing, we urge your Subcommittee to abandon the approach based on the neutrality principle, and that the revised business-continuity test (as recommended above) be made applicable to all loss corporations. The revised business-continuity test should not be a limited rule applying only to bankrupt and insolvent corporations. If the test were so limited, it would encourage some loss corporations to file for otherwise-unnecessary chapter 11 protection, which would place an excessive burden on our country's bankruptcy system.

We believe that the present treatment of the following transactions discussed in the Staff's Report should be retained to promote the rehabilitation of distressed corporations:

(1) Tax-free stock-for-stock acquisitions (under §368(a)(1)(B)). The Staff Report indicates that these acquisitions "are outside both the reorganization rule [under §382(b)] and the purchase rule [under §382(a)]." In the case of stock-for-stock acquisitions, however, the business of the loss corporation is retained in its own, separate corporate shell with no addition of profitable new assets as part of the reorganization. Under the separate return limitation year ("SRLY") rules of Treasury regulation §1.1502-21(c), the loss corporation's historic business must be rehabilitated in order to utilize the loss carryovers.

The expanded business-continuity test recommended above should be sufficient to prevent abuses if additional profitable assets are infused into the loss corporation's shell at a later date.

(2) Triangular Reorganizations. Section 382(b)(6) of present law contains a triangular-reorganization exception. Under the exception, a profitable parent corporation can use a controlled subsidiary to acquire the business and tax carryover history of a loss corporation. Even though an acquisition directly by

the parent would cause reduction of the net operating loss carryovers (under §382(b)'s 20-percent continuity test), the transaction can be structured to ensure full survival of the carryovers.

We believe that the limitations described above applying to stock-for-stock reorganizations will be adequate to prevent abuses in this type of transaction.

Recommended Expansion of Stock-for-Debt Exception

The Staff Recommendations contain a blanket exemption for stock-for-debt exchanges in title 11 bankruptcy cases and similar judicial proceedings. Under the exemption, a stock-for-debt exchange would have no effect on the net operating loss carryovers provided the loss corporation's shareholders and former creditors would retain control of the outstanding stock.

However, net operating loss carryovers would be completely eliminated if another 50 percentage point equity shift occurs within two years of the stock-for-debt exchange.

If the general approach of the Staff Recommendations is adopted as proposed legislation, we strongly urge:

(1) That the blanket exemption covering stock-for-debt exchanges be expanded to include all financially distressed corporations, to avoid otherwise-unnecessary chapter 11 filings; and

(2) That the two-year restriction on subsequent 50 percentage point ownership shifts be eliminated, so as not to impair the loss corporation's ability to attract capital essential to the rehabilitation of its business. In many instances, a potential outside investor will defer his actual contribution of capital to the financially troubled corporation until the company emerges from its chapter 11 proceeding or achieves a composition with its creditors. In this way, he is assured that his capital infusion will be used for rehabilitation of the business and not for payment to creditors.

Interest Deductions Should not be Disallowed

Finally, the Staff Recommendations contain a rule providing for disallowance of deductions for interest paid during a three-year period, with respect to debt that is exchanged for stock in a title 11 or similar proceeding. The reason advanced for this provision is that the debt exchanged for stock would in reality have been equity at the time the interest would have been paid.

We believe that your Subcommittee should not adopt the proposals disallowing interest deductions for the following reasons:

(1) The disallowance would apply primarily to stock-for-debt exchanges outside of formal bankruptcy proceedings. Section 502 of the Bankruptcy Code disallows claims for interest accruing after the commencement of a bankruptcy case, except in certain cases when the value of collateral is sufficient. Consequently, with the terms of many bankruptcy cases exceeding two and even three years, it is doubtful that the recommendation to disallow interest deductions would net for the Treasury any significant revenues with respect to corporations undergoing formal bankruptcy proceedings.

(2) The limited application (i.e., primarily to corporations outside of formal bankruptcy proceedings) suggests that the provision to disallow interest deductions may be an unwarranted complication of our tax system.

(3) The mere fact that interest is paid in cash during a period of financial difficulty is a conclusive indication that the related debt obligation is in fact debt and not equity at the time of the payment.

Conclusion

The carryovers of a bankrupt, insolvent or financially distressed corporations often are significant "off balance sheet" assets, facilitating the rehabilitation of the company. We urge that the legitimate use of these carryovers not be eliminated.

We appreciate this opportunity to submit written testimony concerning possible new legislation on net operating loss carryovers. We would be pleased to discuss these recommendations in greater detail with you or your staff. Please contact either Kenneth Malek (at 312-644-7400) or Jack Salomon (at 212-909-5399), of our Tax Committee.

Very truly yours,
ASSOCIATION OF INSOLVENCY ACCOUNTANTS

By
Kenneth J. Malek
Chairman, Tax Committee

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September 18, 1985

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Attn: Ms. Betty Scott Boom

COMMENTS OF GEORGE BRODE, JR. FOR THE RECORD WITH RESPECT TO THE PROPOSED SUBCHAPTER C REVISION BILL OF 1985

My name is George Brode, Jr., I am a sole tax practitioner specializing in Federal income tax matters for closely held corporations and their shareholders in Chicago, Illinois. I have recently acted as Special Tax Counsel to the Illinois State Bar Association and the Chicago Bar Association, past Chairman of the Section of Taxation of the Illinois State Bar Association, past Chairman of the Subcommittee on Redemptions, Committee on Closely Held Corporations, American Bar Association Section of Taxation, author of BNA Tax Management Portfolio 8-4th Corporate Acquisitions - - Planning, and General Editor of a two volume book entitled Closely Held Corporations published by the Illinois Institute for Continuing Legal Education. The following comments reflect my own personal opinions and should not be construed as representing the opinion of any bar association.

In General

The tax laws governing the taxation of corporations and their shareholders in corporate acquisitions have been in place for more than 30 years. A well understood body of caselaw and statutory law has been developed under these provisions. In May, 1985, the staff of the Senate Finance Committee proposed the "Subchapter C Revision Act of 1985" which contains a set of statutory recommendations that would radically modify the rules for structuring corporate acquisitions and the manner in which the parties are taxed.

It is my opinion that these proposals contain a bias in favor of large publicly held corporations and against small closely held corporations. The proposed rules would provide flexibility for large publicly held corporations in structuring their acquisitions. It would appear that Treasury is willing to accommodate the desires of big business provided it can extract more tax. However, Treasury expects to secure that tax not from the large corporations who receive the benefits, but rather from small closely held family corporations who receive nothing under the bill. As such, the imposition of tax falls on those taxpayers who are least able to defend themselves or express their point of view.

I believe that Congress should reject the acquisition proposals, reject repeal of General Utilities, and retain current law. Alternatively, in the event that Congress sees fit to enact some form of legislation along these lines, I have included certain suggested technical changes and comments which I believe will clarify the proposed bill. The reasons for my request are more fully set forth below.

No Benefit To Closely Held Corporations

The Senate Finance Committee Staff Report (hereinafter "Staff

Report") provides a set of acquisition proposals that include explicit elective treatment of the transaction at the corporate level, separates corporate level tax consequences from shareholder level consequences, and permits shareholder consequences to be determined independently of the tax consequences to other shareholders or investors. Staff Report, at 58. These proposals were put forth by the American Law Institute, certain bar groups, tax practitioners, and academicians.

Large publicly held corporations want electivity and separation of corporate and shareholder tax consequences. More than 98% of all corporations in this country are closely held corporations whose stock is not publicly traded. How are these corporations benefited by electivity and separation of corporate and shareholder tax consequences? I submit they are not.

The Relief Provision From General Utilities Is Too Narrow

Treasury conditioned its support of the acquisition proposals upon complete repeal of General Utilities, 296 U.S.200(1935), which generally stands for the proposition that a corporation recognizes no gain or loss upon the distribution of appreciated property with respect to its stock. In addition, the Staff Report suggests that the General Utilities doctrine ". . .is also often considered as emcompassing the rule set forth in section 337 of current law providing for the nonrecognition of gain or loss in certain liquidating sales." Staff Report, at 59.

The Staff Report states that:

> ". . . the impact of repeal of General Utilities (and the consequent need for some form of relief) would fall almost exclusively upon small, closely held businesses, and that large, publicly held corporations would rarely be affected." Staff Report, at 63. Based on testimony of John S. Nolan at 148, 151 noted at Staff Report, at 6, footnote 24.

The relief provision that was adopted in proposed section 1060 provides shareholders an upward basis adjustment to their stock to reflect corporate level tax paid on long held capital assets (generally assets held by a corporation for more than 5 years) in certain corporate acquisitions and liquidations involving small businesses (generally defined to mean corporations with a fair market value of up to $1 million, and in decreasing amounts up to $2 million to prevent a cliff effect). Staff Report, at 6-7, 63-68, 239-41.

The proposed relief is extremely narrow. The relief proposal set forth in section 1060 is limited to providing elimination of "double tax" for closely held corporations only in those cases involving long-held capital assets of the acquired or liquidating corporation. I have three principal objections. The calculation as noted on page 239 is not precise, rather it "approximates" the amount of gain, after taxes. Comparing the tax on a sale of assets followed by a liquidation under present law with that of proposed law (using the facts set forth in an example at page 10 below), results in a tax approximately 5% higher. While that is a function of the fact that gain is not recognized to the corporation in a section 337 liquidation, and that a shareholder's capital gain rate is different from that of a corporation, the imprecise nature of the calculation which seems skewed in favor of the Treasury takes on the appearance of a lottery. Secondly, why 5 years, why not 3 years, and why is the formula limited to long held capital assets - - why not all assets on which tax is paid? Finally, and most importantly, why is the relief limited only to corporations having a fair market value below $2 million? That position seems difficult to justify. If repeal of General Utilities creates a "double tax" problem, that problem exists for all closely held corporations, not just those having a fair market value below $2 million.

It is clear that repeal of General Utilties would be a revenue raising measure. This may be surmised by page 68 of the Staff Report which provides, in pertinent part, that:

> ". . . to the extent necessary to keep this bill revenue neutral, it is recommended that consideration be given to an across-the-board reduction of the corporate capital gains tax." See also footnote 160, at 63.

This statement appears to be inconsistent with the Staff Report statement at page 63 that:

> "Providing across-the-board relief in all transactions, liquidating and non-liquidating, seemed out of the question because of revenue considerations."

Put simply, the proposal would take from the poor and give to the rich!

It is therefore my opinion that if Treasury does, in fact, require repeal of General Utilities, the relief set forth in proposed section 1060 must apply across-the-board. To make it less costly, I recommend a compromise. Extend the relief to all corporations whose stock is not publicly traded on a national exchange. That approach would provide consistency by targeting that group of closely held corporations who would be harmed by the "double tax" result of repeal of General Utilities. If consistency is what Treasury seeks rather than revenue, it should be willing to accept that proposal.

No Abuse Exists To Justify Repeal of General Utilities

One might also question the litany of problems attributed to General Utilities by Treasury in order to justify adoption of the sweeping proposed changes. There have been 12 specific exceptions and limitations to the general rule of section 311(a), 336, and 337 which codified General Utilities in the 1954 Code. See Staff Report at 60, 61 which lists the statutory exceptions. Little, if anything, remains to be chipped away. Even if anything was left, Congress is certainly adept at closing down any perceived tax avoidance scheme - - once such abuse has been clearly identified and it is demonstrated that it runs contrary to established tax policy. Simply put, I believe that Treasury has failed to make its case. Accordingly, it should not be permitted to turn back the clock on section 337.

Current Law Works - - Why Change It

While it is true that inconsistencies exist in the continuity of interest rules as between A, B, and C reorganizations and that the rules are somewhat complex, taxpayers who engage in such transactions seek out sophisticated tax counsel to guide them through the various forms of acquisitive reorganizations.

I believe that Congress should retain current law because it's well understood, the rules are in place, and most importantly, it works. The suggested rules are far more complex. Removing the rhetoric, the suggested proposals represent a revenue raising measure with most of the "bill" presented to those closely held corporations who fall outside the relief provisions of section 1060. There have been too many well intentioned proposals spawned by theoreticians which under the guise of "tax consistency", "simplicity", or "fairness" have inundated the tax community with their complexity or failed implementation (e.g., carryover basis, the 1976 section 382 net operating loss rules, and section 338). This endless spate of "make work" legislation must stop. I therefore ask that Congress reject the acquisition proposals, reject repeal of the General Utilities doctrine, and retain current law.

Senate Finance Committee
Page eight - - cont'd
September 18, 1985

Suggested Comments And Changes If Proposed Law Is Enacted

In the event that the proposed law is enacted, I recommend that the following changes be incorporated:

(1) The proposed bill intends to sweep together taxable and tax-free transactions within one uniform set of rules. Notwithstanding that fact, both the statute and the Staff Report fail to discuss the tax treatment that would be accorded the simple "all cash" transaction in which target sells 70% of its gross assets and 90% of its net assets to an acquiring corporation for cash in a taxable situation in which a cost basis election is made and target fails to distribute all of its assets to its shareholders within 12 months of the acquisition.

I therefore recommend that an additional statutory provision be added following section 364(c)(2) to make it clear that in an "all cash" transaction, if target fails to distribute its assets to its shareholders within 12 months following the acquisition, the transaction will be taxable to T, and not T's shareholders. In addition, I recommend that an example be placed into the final committee reports to this effect. Moreover, an example should be placed in the committee reports which demonstrates the tax effect of an "all cash" transaction in which a carryover basis occurs.

(2) The Staff Report at 62 in discussing the consequences following a sale of assets for cash in which a so-called "lack of symmetry" occurs states:

> "Essentially, by liquidating or not liquidating the target corporation, the well-advised can secure a step-up in basis at whatever "price" - - the corporate level tax or the shareholder level tax, if any - - is smaller."

It then cites footnote 154 which says:

> "Where the corporation's basis in its assets is greater than the shareholder's basis in his stock, the taxpayer can pay the small corporate level tax and avoid the large shareholder tax by not liquidating the corporation. It may be possible to continue to operate the corporation as a holding company making investments while avoiding the personal holding company penalty tax."

The Staff Report then goes on to state:

> "Obviously, to the ill-advised, these same rules can operate as a trap, producing a disportionally large tax liability. No policy reason could be found for continuing this asymmetrical effect which often operates to the detriment of small, closely held family businesses that are not well advised."

Read literally, that language would appear to close down the opportunity to retain the corporate existence following a sale of assets. That would have the effect of forcing shareholders to recognize gain in connection with an asset acquisition for cash and thereby deny such shareholder the right to hold the stock until death and secure a section 1014 step-up in basis. In a phone conversation with Mr. George Yin, Tax Counsel to the Senate Finance Committee on September 9, 1985, the undersigned was advised that the Senate Finance Committee did not intend that result.

In order to avoid any possible confusion as to the meaning of the above quoted language on page 62 of the Staff Report, I recommend that the final committee reports contain an example of an "all cash" transaction in which the corporation has a high inside basis in its assets and the shareholders have a low outside basis in their stock. This example would hopefully make clear that (i) if target fails to distribute its assets to its shareholders within 12 months under proposed section 364(c)(2), tax would only be imposed on T and P, and not T's shareholders, (ii) T could be kept alive and maintained as a holding company, and (iii) if the shareholders of T held their stock until their death, no tax on the built-in appreciation in value of their T stock would result by reason of section 1014.

The following specific example could be utilized to demonstrate the tax ramifications of the above:

> Individual A owns all of the stock of Corporation T. T's assets were recently sold for $1,000,000 and T has a basis in those assets of $900,000. A's basis in the stock of T is $100,000. In this example, if

Senate Finance Committee
Page eleven - cont'd
September 18, 1985

T's assets are not distributed to its shareholders within 12 months following the acquisition, T's realized gain on the sale of assets of $100,000 ($1,000,000 received less T's $900,000 basis) would be recognized and its tax would be $28,000 (28% of $100,000). By not distributing the assets following the acquisition, T would have cash of $972,000 to invest in a portfolio of investment securities. If A held the stock of T until his death at which time the stock had a fair market value of $1,000,000, A's heirs would secure a stepped-up basis under section 1014 and thereby avoid the payment of any income tax on the $900,000 of appreciation in value of T stock ($1,000,000 value less A's $100,000 basis). This result is consistent with present law.

That concludes my remarks. Thank you for the opportunity to submit remarks for the record.

Respectfully submitted,

George Brode, Jr.

GB:mm

B

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Ms. Betty Scott - Boom
Senate Committee on Finance
SD - 219
Dicksen Senate Office Building
Washington, DC 20510

Dear Ms. Scott-Boom:

In response to a September 12, 1985, letter from William M. Diefenderfer, Chief of Staff of the Senate Finance Committee, I am sending my comments to you on the proposals to revise Sub-chapter C of the Internal Revenue Code. I have broken my comments down by code sections.

Section 351

While this area is being discussed in the proposed legislation, it would seem to be a good time to address not only the proposed legislation, but also a couple of other areas which could possibly be added to Section 351 to simplify the incorporation of small businesses. There should be a threshold so that there are slightly less stringent rules for capatilization of under $1,000,000. The first is in the area of services. Old Section 351 (d)(1) and proposed section 351(e)(3)(A) still state that stock issued for services cannot be considered in the test for 80% control. I submit that it should be amended to allow for stock issued for services to qualify. In small businesses, it is relatively common for one or two

MEMBER OF THE PRIVATE COMPANIES PRACTICE SECTION AND THE SEC PRACTICE SECTION
OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

individuals to invest property or cash, whereas a third (generally, someone a lot younger) gets stock for his future services. The investors want to be able to get someone to own an interest in the business so he will stick with it and have the incentive to make it successful. The rules of Section 351 make it almost impossible for him to receive over 20% of the stock. This rule, compiled with the complexities of Section 83 (relating to property transferred for sevices), are substantial impediments to the start up of small businesses.

Secondly, control needs to be defined to include related parties under Section 318. This will eliminate both the trap for the unwary of Fahs vs. Florida Machine and Foundry, 5th C.A., 168F.2d957, and the tax planning opportunities which it proposes. It is a trap for the unwary, because many samll businessmen use the step of incorporation as a chance to allow other family members to have an interest in the business. Generally, many small businesses which are run as sole proprietorships include both the husband and wife as key parties. However, because of inordinately high self employment taxes, all income is reported as husband's and the business is treated as owned by husband. Upon incorporation, it is desired that wife should receive some portion of the stock. Under Fahs vs. Florida Machine, this has to be done in a purely unnecessary paper transaction of a 100% stock issuance (to satisfy the control requirement) and then a subsequent gift to wife. Most people aren't aware of the case and its potential impact if the stock is issued directly to wife (or any family memeber) for more than 20%.

On the flip side, it offers a good tax planning tool if it is desired that the incorporation be taxable to receive a step up in basis on assets. It can be accomplished through a simple direct issuance of 21% of the stock to a family member. Since husband will still be in control and can even have buy back arrangements on the stock, this is a purely fictional transaction which should not, but does, receive step up in basis treatment.

Thirdly, I submit that there should be something to allow the following situation to be handled more easily . A has a 100% owned corporation named ABC, Inc. B has a sole proprietorship in the same type of business as ABC, Inc. For genuine, non-tax business reasons, they want to go into business together. Currently, this requires the formation of a new corporation with a contribution of assets and liabilities of ABC, Inc., and the sole proprietorship to Newco, with a liquidation of ABC under 351(c). It is submitted that B should be able to directly contribute to existing ABC or that ABC should be allowed a non-taxable liquidation in order to be able to contribute all of its assets to a partnership.

With regards to your proposal regarding securities received to be taxed as under Section 354, I think it should be eliminated. As is, if securities are used, they are taxed to the contributing shareholders when they are paid. Since the shareholders pay the tax on them when they get their cash, the transaction is in line with our general system of taxation to allow for taxation when the gain is actually realized.

Also, the proposal relating to defining control as related to value under Section 1504(a)(4) and (5) can potentially only add confusion to this area.

In a situation where A has 75% and B has 25% and B is contributing services, A's plan may be to have a taxable transfer to get the step-up in basis on assets. However, with the definition of control including value, the IRS can easily argue that this particular situation is non-taxable because the 75% ownership is worth more than 80%, because it represents voting control of the business.

Amendements to Section 333

Generally, if Section 333 is going to have to apply to the liquidation of all corporations, the time frame must be longer. Now with the one month time frame, it is generally not a problem to get these liquidations done in one month since the corporation actually being liquidated is usually simple, with few assets and liabilities. However, under the proposed legislation, Section 333 will apply to much larger, more complex types of liquidations which will be almost impossible to get completed. It will require some type of relief. Under current law, it is sometimes very difficult from a practical business standpoint to get a 337 liquidation completed in the 12 month period.

Also, the "one calendar month" rule should be eliminated. It should be a more reasonable time frame that will not necessarily trap people who attempt a liquidation starting on the 29th of a month and having to get it accomplished in two (2) days. It should be specifically made thirty days.

The rule requiring all earnings and profits to be taken out of the corporation as a dividend should not be put into effect. The capital gain provisions make it much more attractive for small businesses to enter into sales of their businesses to larger, more efficient operations. If the earnings and profits are to be taken out at dividend rates, it will result in two distinct changes in corporate strategy. First, the incentive to accumulate money in the corporation will be reduced, thereby penalizing small business people who desire to leave the profits in the corporation to build capital to expand the businesses. These business people will then either attempt to take more of the earnings out, either through salaries or through "S" status. Either method will hamper the ability to raise and/or accumulate capital to stimulate business expansions and economic growth in the economy. Secondly, a potential sale of the business will be greatly hampered. Therefore, the expanding, acquiring business will have a more difficult time convincing a small corporation, which is a potential purchase candidate, to sell, if its earnings and profits are to be treated as dividend upon liquidation.

At the very least, there should be a transitional rule which would allow existing corporations to file with the IRS the amount of their E and P at the effective date of the new legislation and allow that much of a later liquidation to be taxed at capital gains rate, and the E and P accumulated after the date of the law to be taxed as dividends.

Unless, some change is made to the provisions of IRS (Section 302) and the reporting of sales of the stock there is going to be unequal treatment allowed to shareholders who are redeemed instead of liquidated or for shareholders who actually sell their stock. In addition, this will put a premium on a sale of stock instead of an asset acquisition in any purchase of a corporation. This will penalize people who for non-tax business reasons have to sell assets of a corporation instead of the stock. From a practical matter, many purchasers will not purchase stock, either because the corporation has unwanted assets or potential liabilities.

Thank you for your consideration of these comments.

Sincerely yours,

Thomas B. Butchart

Thomas B. Butchart, CPA

TBB:mlr

C

STATEMENT BY

JOHN P. MASCOTTE
CHAIRMAN OF THE BOARD
AND CHIEF EXECUTIVE OFFICER
THE CONTINENTAL CORPORATION

CONCERNING
TAX ASPECTS OF MERGERS AND ACQUISITIONS

HEARINGS CONDUCTED
BY THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

APRIL 22, 1985

Continental
Insurance.

Senator Chafee, other distinguished members, I appreciate the opportunity to offer these comments on behalf of The Continental Corporation, one of America's largest independent property-casualty (p-c) insurers.

I would like to bring to your attention those provisions of the Internal Revenue Code considered in the takeover of a p-c company -- the consolidated return provisions of the Code and the deemed asset purchase provision of the Code (i.e. Section 338).

A p-c company generates large tax losses which often exceed its economic losses. This phenomenon is a function of state regulatory accounting adopted by the tax law and the exemptions offered by the Code to all p-c companies. Under state regulatory accounting, a p-c company defers income receipts and deducts immediately the expenses in earning that income; in addition, a p-c company deducts in advance its estimate of losses incurred and its estimate of what settlement expenses will be, In this connection, a p-c company also has the option of investing its reserves for unearned income, losses and expenses in securities which yield tax sheltered income, i.e., tax exempt bonds and stocks.

The tax accounting rules for p-c companies have as their underlying purpose the preservation of the solvency of p-c companies which, incidentally, is also the state regulatory purpose. In this manner, the interests of all policyholders is protected, moreover, the Treasury is protected as long as other parties cannot avail themselves of the p-c statutory accounting rules to utilize otherwise unutilized tax losses.

The delicate balance between protecting policyholders and the Treasury is destroyed when others can avail themselves of the tax accounting rules applicable to p-c companies. This can occur when a non p-c company acquires a p-c company and files consolidated returns to utilize its losses, losses that a non p-c company could not otherwise generate as under state law it cannot operate a p-c business directly. Indeed, the non p-c company will pay for the future tax benefits to be generated from the target p-c company. These tax benefits can be multiplied if a Section 338 election is made with respect to the target p-c company.

A Section 338 election can multiply the tax benefits of the target p-c company because the economic profit inherent in the existing reserves of the p-c company can be turned into a tax deduction even though a substantial portion of that economic profit may be attributable to future tax sheltered income. Just for one large acquisition the loss to the Treasury over a period of time on account of the consolidation and Section 338 election rules can amount to several hundred million dollars.

The obvious tax incentives in acquiring a p-c company can lead to acquisitions that are not economic. The acquisition history of Baldwin-United and its ultimate downfall is a case in point. Other acquisitions where the tax rules played an important role are well documented and are a matter of public record. Indeed, today more than one half of the largest p-c underwriters are owned by non p-c companies. See Exhibit 1. An interim Treasury study due in July of 1986 will demonstrate how badly the fisc is effected just by consolidation with life companies. When one considers the benefits non insurance companies obtain under the consolidation - Section 338 rules, it is apparent that corrective legislation eliminating these rules is necessary.

EXHIBIT ONE

The following list illustrates the consolidated groups which are affiliated with more than half of the 25 largest p-c insurers:

1. State Farm [affiliated with State Farm Life]
2. Allstate [owned by Sears, Roebuck, affiliated with Allstate Life]
3. Aetna Casualty & Surety [affiliated with Aetna Life]
4. CIGNA [the company created by the acquisition of INA by Connecticut General Life in 1982]
5. Travelers [affiliated with Travelers Life]
6. Farmers [independent]
7. Continental [independent]
8. Liberty Mutual [independent]
9. Hartford Fire [owned by ITT]
10. Fireman's Fund [owned by American Express, affiliated with IDS Life]
11. Nationwide [affiliated with Nationwide Life]
12. U.S. F & G [independent]
13. Crum & Forster [bought by Xerox in 1983]
14. Kemper [independent]
15. Home [owned by City Investing]
16. St. Paul [independent]

17. AIG [independent]

18. Commercial Union [independent]

19. CNA [owned by Loews and affiliated with CNA life companies]

20. Royal [independent]

21. Chubb [independent]

22. USAA [independent]

23. Prudential [owned by Prudential Life]

24. American Financial [an insurance holding company with both life and property-casualty subsidiaries]

25. Reliance [bought by Leasco, now Reliance Group].

Commercial
Law
League
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September 30, 1985

Hon. Robert Packwood, Chairman
Senate Finance Committee
215 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: Carryovers of Net Operating Losses
In Bankruptcy Related Cases

Dear Senator Packwood:

In connection with the hearing by the Committee today with respect to Subchapter C problems, the Commercial Law League urges that present provisions of law be continued, as an exception to any change in the general rule, with respect to the carryover of net operating losses of companies involved in a financial reorganization, usually under Chapter 11 of the Bankruptcy Code.

We believe that current limitations adequately protect against trafficking in carryovers of NOL's in such situations and that the carryover of NOL's is necessary to secure the infusion of additional capital to continue the business operation of the debtor company and to permit distributions to creditors as part of the reorganization.

A summary of this problem, and certain proposals for limitations on the use of NOL carryovers, is in the enclosed copy of an article, "Carryovers of Net Operating Losses in Bankruptcy Related Cases", in the June-July, 1985 issue of the Commercial Law Journal.

We respectfully request that this letter and the enclosed article be included in the record of the hearing today by the Senate Finance Committee.

Sincerely yours,

Benson Zion

Benson Zion
President

Carryovers of Net Operating Losses in Bankruptcy Related Cases

COMMERCIAL
LAW
JOURNAL

The NOL and Chapter 11— Are More Changes Coming?

Charles M. Tatelbaum
of Baltimore, Maryland

On May 22, 1985, the Subcommittee on Select Revenue Measures of the U.S. House Ways and Means Committee held a hearing on special limitations on the use of net operating loss carryovers and other tax attributes of corporations. While it now seems apparent that the staff of the Subcommittee spent a considerable period of time in preparation for the hearing, public notice of the proceedings was limited. The purpose of the hearing was to review changes to the current law dealing with net operating loss carryovers (NOL's) and Section 382 of the Internal Revenue Code.

As most business people and attorneys are aware, a corporate taxpayer is permitted to carry forward a net operating loss for use against future income, as well as being able to utilize certain tax credits in the future. Additionally, these tax attributes can be carried over to another corporation as a result of certain tax-free acquisitions. The law has limitations with respect to the utilization of the NOL, especially when there has been an acquisition of the ownership of the entity holding the NOL. The Tax Reform Act of 1976 amended the law with respect to the limitations on these transactions and acquisitions, but the effective date of the amendments has been delayed numerous times so that the law originally scheduled to become effective in 1978 now becomes effective January 1, 1986. The House has indicated that a new bill will be enacted (or the 1976 Code reaffirmed) long before the end of 1985 and independent of the President's tax reform proposals.

There are three proposals presently under consideration by the House. First, the pre-1976 law (presently in effect) would remain in place. Secondly, the American Law Institute has put forward a proposal for amending the Code, and finally the ABA Section on Taxation has developed a proposed law dealing with NOL's and their limitations.

General Rules Presently in Effect

Even though there must be annual returns filed by the corporate taxpayers, these taxpayers are permitted to utilize the NOL's and the other attributes for a period of up to fifteen years, charging them against future income. The rationale for this is that taxpayers should be able to average income and losses from a business over a period of years in order to reduce the disparity in tax treatment of business entities that experience fluctuations with respect to income. Since there are a number of investment incentives, there is a deliberate mismatch of income and related expenses, and this further justifies the rationale of the NOL. An NOL may be carried back three years and forward for fifteen. With respect to the carryback, a refund is generated, while a credit is used in the carryforward.

There is a perception among certain specialists in the field, as well as the IRS, that there is trafficking in NOL's to the end and effect that corporate shells with substantial losses are acquired by profitable companies for the sole purpose of utilizing the existing NOL. As a result limitations have previously been imposed to attempt to dissuade the trafficking in NOL's. While there are some exceptions contained in Section 368(a)(1) of the Internal Revenue Code, carryovers to a successor corporation must meet the current stringent tests in order to utilize the NOL. At present, the IRS is permitted to disallow deductions, credits and other allowances following the acquisition of control of a corporation or a tax-free acquisition of a corporation's assets if the principal purpose of the acquisition was tax avoidance. Treasury regulations dealing with Section 269 of the Internal Revenue Code (the tax avoidance section) provide that the acquisition of assets with an aggregate basis that is materially greater than their value coupled with the utilization of the basis to create tax-reducing losses, is indicative of a tax-avoidance motive. A successor entity or an acquirer must also continue the business operations of the entity with the NOL under a strict set of guidelines in order to maintain the availability of the NOL's.

The Treasury Department claims that the law must be amended to prevent:

1. Trafficking in loss corporations.
2. Windfalls to an acquiring corporation that did not suffer the loss.
3. The offsetting of losses incurred in one business against profits of an unrelated business.
4. The distortion of economic decisions regarding transactions involving loss corporations.

Since it appears that the 1976 amendments will not be the statute to become effective, these amendments will not be discussed.

The ALI Proposal

The American Law Institute claims that it has eliminated the lack of coherent rationale for imposing limitations on the use of tax attributes after substantial change in ownership. The ALI has proposed special limitations that are claimed to be designed to reduce the significance of NOL carryovers in making investment decisions and to promote tax neutrality by preventing new owners of a loss corporation from using NOL carryover more rapidly than it would be used had there been no change in ownership.

The ALI's rule is known as the Merger Rule and is based upon a pool of capital concept. Under this concept, NOL carryovers should be unavailable, except to the extent of earnings that are attributable to the pool of capital that created the losses. The rule is intended to create the same results that would occur if a loss corporation's assets were combined with those of a profitable corporation in a partnership. The ALI claims that this treatment can be justified on the ground that the option of contributing assets to a partnership is available to a loss corporation. In such a case, only the loss corporation's share of the partnership's income could be offset by the NOL carryover.

The Merger Rule would provide that if a loss corporation's assets are combined with those of a profitable corporation in a non-taxable transaction, the portion of the post-acquisition income to be offset by the loss corporation's NOL carryover would be limited to the income generated by assets that the loss corporation contributed to the combined enterprise. The ALI proposal provides that the earnings attributable to assets contributed by the loss corporation be determined generally by reference to the percentage of the acquiring corporation's stock issued to the loss corporation's shareholders. Where a loss corporation's assets are acquired for preferred stock, the use of NOL carryovers would be limited to the dividends payable on such preferred stock.

The ABA Proposal

The ABA Section on Taxation has adopted a purchase rule which provides for an annual limitation on the use of NOL carryovers equal to a deemed rate of return on the price paid for the purchased stock. It is claimed that this limitation is designed to prevent new owners from infusing new capital into a loss corporation to obtain greater utilization of NOL carryovers than the old owners could have. The ABA proposal provides for a limitation that would permit the use of NOL carryovers to the extent of built-in gains recognized within five years after the change in control, plus twenty-four percent of the purchase price each of the five years following the change. The ABA claims that this is based on a neutrality concept which claims that the new owners of a loss corporation should be able to use a NOL carryover only to the same extent that the old owners could have. This proposal makes the assumption that the value of the loss corporation—as distinguished from the purchase price of its stock or assets—is the proper measure of future earnings. The price would be reduced by the value of assets contributed to the loss corporation during the two year period preceding the transaction in order to eliminate the inflation of equity.

At the hearing on May 22, 1985, James B. Lewis, Chairman of the ABA's Section of Taxation, testified as to the strength of the ABA proposal. It appears that most of the testimony related to the ABA proposal and whether or not it should be the adopted resolution.

Under the ABA proposal, a purchasing entity could use two percent per month of the equity in the purchased corporation to the extent of sixty months. Thus, in a full taxable year, 24 percent of the equity could be used, or 120 percent of the equity over the full five years. The 120 percent figure is claimed to provide for the present value of the equity. The ABA's proposal would be triggered when there is a transfer or an integrated series of transfers effecting a 50 percent change in equity ownership. Unfortunately, there is no specific time frame during which the transfers are to be measured and this can create severe uncertainty as to when there would be a Section 382 application. For instance, a purchaser of a 45 percent interest in a loss corporation may have no control over unrelated transfers such as a sale by one or several parties of a very minority interest to another purchaser unrelated to the 45 percent purchaser. This would have a disastrous effect on securing a fair price for the stock in a legitimate transaction.

The ABA proposal does attempt to take into account the problems dealing with debt-ridden corporations. It states that any amounts paid for the loss corporation's debt could be utilized in determining the extent of the NOL. However, the ABA says that this debt must be "old and cold"—more than two years old on the date of the change in control and further that the debt is converted into equity either prior to the change in control or promptly thereafter. This proposal fails to recognize the very serious problems that develop with financially reorganized entities, and the need for the infusion of capital in order to effect a financial reorganization and ultimate payment to creditors.

The League's Position on Problems in Financial Reorganizations

This author was called to testify on behalf of the Commercial Law League of America in opposition to all of the proposals as they are presently written because of their failure to provide for a meaningful exception in or relating to a financial reorganization.

Practitioners familiar with Chapter 11 reorganizations and other out-of-court compositions recognize that many times a Plan of Reorganization can only be successful if new capital is found. In these instances, a successful entity will acquire a financially distressed debtor in the same line of business in the hope of being able to reorganize the entity into a profit-making enterprise. The money paid for the stock is certainly not based on actual equity, but rather is speculation based upon future earning abilities, and the utilization of the NOL. Additionally, in most instances, the consideration paid is the only means for effecting a distribution to unsecured creditors of the debtor.

The Commercial Law League's position is that the current limitations that exist adequately protect any claimed trafficking in NOL's, and, at the same time, encourage distributions to creditors as part of reorganizations. The current limitations on the continuity of business operations contained in Section 382 plus the provisions of the Bankruptcy Tax Act of 1980 clearly limit any nefarious use of the acquisition of an entity for pure tax avoidance purposes. Under the Bankruptcy Tax Act of 1980, the NOL (or basis of capital assets) is charged or has a deduction for the amount of debt that is forgiven in the financial reorganization. This then discourages the effecting of a minimal payment to creditors, and the attempted maximization of the use of the NOL. To follow the ABA's proposal, where utilization of an NOL is based on equity 120 percent (over five years) of a no-equity entity would provide for absolutely no utilization of the NOL. Thus, acquiring entities would be totally discouraged from speculating on the future operations of a debtor when there would be no incentive by the use of the NOL's. The tax attributes have already been earned by the loss corporation, so that the Internal Revenue Service would not be hurt.

The purpose of the financial reorganization is to rehabilitate the taxpayer so that it can become a meaningful business entity. Future taxes will be paid after the utilization of the NOL's, and employment will be fostered. It is interesting to note that a number of the witnesses, including Donald R. Alexander, former Commissioner of Internal Revenue, indicated that there should be some exception in whatever rule is passed for the Chapter 11 situation. Based on questioning of this author as a witness, it is anticipated that the NOL's use might be limited to seven or eight years rather than the current fifteen in the exception, but that an exception will be made for the Chapter 11 situation.

Conclusion

There is no question that notwithstanding what Congress does with President Reagan's current tax proposals, something will have to be done with Section 382 dealing with NOL's prior to the end of 1985. Business people and legal and accounting practitioners should remain alert for further information dealing with proposed changes. It is hoped that the Subcommittee members and the full Ways and Means Committee will be responsive to the real needs of the business community with respect to any amendment to Section 382, and not be guided by fears of massive trafficking in NOL entities.

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WRITTEN TESTIMONY OF JOHN F. ELLINGSON
SUBMITTED TO
COMMITTEE ON FINANCE
SEPTEMBER 30, 1985

INTRODUCTION:

I am John F. Ellingson. I am a lawyer from Bellevue, Washington, a Seattle suburb. My practice is limited to the rehabilitation of debtor companies. I formerly chaired the American Bar Association Young Lawyer Division Subcommittee on Tax Treatment in Bankruptcy.

PREMISE:

That insolvent corporations should not be required to give up their tax history in order to recover their financial health.

POLICY:

Present policy regarding insolvents is contained in the Bankruptcy Code, 11 U.S.C. that policy, which carried over from the Bankruptcy Act of 1898, promotes the rehabilitation of insolvents. The policy was affirmed by the provisions of the Bankruptcy Tax Act of 1980, which facilitated the tax-free rehabilitation of insolvent corporations by adding Section 368(a)(1)(G) to the Internal Revenue Code.

CURRENT PROPOSALS:

The current proposals of both the House of Representatives Committee on Ways and Means and the Senate Committee on Finance recognize the need for special treatment of insolvent corporations. However, both proposals fail to adequately address the reality of the rehabilitation process. In fact, the Senate Finance Committee proposal is anti-rehabilitation, though this position is probably unintentional. Both current proposals have their roots in the American Law Institute and American Bar Association position. The premise for this position is that "trafficking in losses" is wrong and that the survival of net operating losses should have some relationship to the net worth of the enterprise. Whether or not this logic makes any sense in the real business world is a discussion I leave to others.

However, this logic breaks down completely with an insolvent corporation with a negative net worth. This logic makes the rehabilitation of an insolvent corporation more difficult. It is presumed in my discussion that it is in the best interest of the insolvent corporate tax payer, its customers, employees, and creditors to rehabilitate such a corporation, if rehabilitation is practical. It is my position, based on years of experience working in the area of rehabilitating debtor companies, that there are many obstacles to overcome in attracting fresh capital to a debtor company (either debt or equity) and financially restructuring the debtor. To add an obstacle, such as extinguishing all or part of the debtor's tax history may for some debtors be the final straw.

A very large percentage (nearly 100%) of the successful Chapter 11 rehabilitations require the infusion of fresh equity dollars or the substantial conversion of debt to equity. The Senate proposal recognizes the need to convert debt to equity free of penalty in that there would be no reduction in net operating losses in a transaction in which creditors take stock in exchange for debt. (This is a codification of the existing common law "Stock for debt exception"). However, the Senate proposal would extinguish the entire tax loss history if fresh equity were contributed to the debtor or a rehabilitating merger consummated within two years of the initial debt for equity exchange. To suggest that a debtor company can rehabilitate itself without outside capital is unrealistic. If this were possible the company would not be in a bankruptcy proceeding to begin with. The result of this proposal, if enacted, would be to discourage , or delay, or possibly deny a debtor corporation access to the equity capital markets and deny the route of rehabilitation through tax-free merger.

While the concern that seems to dominate the thinking of the Senate, the House of Representatives, the Treasury Department and the Joint Committee is the prevention of abusive "trafficking in losses", we must guard against preventing rehabilitation along with preventing abuse.

We need only to examine the situation in today's economic climate to come to the realization that billions of dollars in assets and possibly millions of jobs are involved with the rehabilitation of debtor companies. Continental Airlines, Braniff, Wickes, Saxon Industries, Pittsburg Wheeling, U.P.I., etc.; all household names; would these entities make it under the current proposals? I think not. In all of these cases it required or will require fresh equity capital or a rehabilitating merger to rehabilitate the debtor.

The present proposals are revenue negative. Can the U.S. economy afford to write off a significant portion of our operating assets contrary to the rehabilitation policy of the Bankruptcy Code? With the trouble in the banking and thrift industries we can expect more major bankruptcy filings. What is the probable effect if we don't rehabilitate these debtors? Loss of tax revenue in personal income tax from all of the employees who would lose their jobs, state and local taxes would go uncollected, payments under entitlement programs would go up. Therefore, the passage of a tax policy that discourages rehabilitation of debtor corporations would be very revenue negative. Is this something we can afford when the major problem facing the federal fisc and the country is the size growing deficit?

I believe that the treatment of pre-petition interest deduction included in the Senate proposal is fair, I take exception to the arbitrary time limitation applied as not being related to reality.

While I do not seek special treatment for debtor corporations once they become solvent, we must not place additional road blocks on the road to recovery. Tax legislation should be consistent with the existing bankruptcy law policy of encouraging rehabilitation.

PROPOSAL:

In its simplest terms, I propose to create an absolute exception to the reduction of tax attributes of an insolvent corporation for any action taken as part of a plan of rehabilitation. This would apply to infusion of fresh equity whether by purchase, conversion of existing debt or merger. To prevent abuse I would require only that some significant portion of the prerehabilitation business enterprise continue after taking into account contractions in business activity brought about by the financial distress of the company. I would not require any test of continuity of ownership interest.

While such treatment should be available to corporations in a Chapter 11 or similar proceeding, including a workout, it should also be available to those corporations that are not eligible for relief under the Bankruptcy Code, such as banks.

Once the corporation becomes solvent the taxpayer should receive the same treatment accorded all other corporate taxpayers.

CONCLUSION:

Insolvent corporate taxpayers should be treated in a manner consistent with a policy of encouraging rehabilitation. Current proposals fail to do so. It is revenue positive to give special treatment to insolvents. Once solvent all taxpayers should be treated the same.

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STATEMENT OF JERALD DAVID AUGUST
SPECIAL TASK FORCE OF THE
CORPORATIONS COMMITTEE OF THE
TAX SECTION
OF THE FLORIDA BAR

BEFORE THE

SENATE FINANCE COMMITTEE
UNITED STATES SENATE

Hearing on The Subchapter C Revision Act of 1985

September 30, 1985

My name is Jerald David August. I am Co-Chairman of the Corporations (Regular) Committee of the Tax Section of the Florida Bar. This Statement expresses the views of certain members* of the Corporations Committee ("Task Force") which was organized to study and comment on the present proposals to enact major reforms to the federal income taxation of corporations and their shareholders. 1/ The statements and comments set forth herein represent only the views of the Task Force and should not

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1/ This Statement is in response to the recommendations to revise Subchapter C of the Internal Revenue Code contained in the "Final Report on Subchapter C--The Subchapter C Revision Act of 1985", prepared by the Staff of the Senate Finance Committee, 99th Cong., 1st Sess., S. Prt. 99-47 (May, 1985) (hereinafter referred to as the "Final Report").

* Harry J. Friedman, Co-Chairman, Miami, Florida, also participated in the submission of this Statement. Other members of the Task Force are Donald Duffy, Charles R. Glasheen, Jack A. Levine, Sydney S. Traum and August Van Eepoel.

be construed as representing the views of the Corporations Committee, the Tax Section, or of the Florida Bar as such. 2/

The Final Report recommends that fundamental and far reaching changes be made with respect to the taxation of corporate transactions. Many of the current proposals were previously set forth in a Preliminary Report of the Staff and have already received much comment and review from Department of the Treasury, staffs of the Joint Committee on Taxation and House Ways and Means Committee, and members of various professional organizations, the academic community and private industry. 3/ A few of these proposals were enacted into law as part of the Deficit Reduction Act of 1984, P.L.98-369. Cognizant of the collegial atmosphere in which these recommendations have been received, we welcome the opportunity to enter into the process and submit comment. Although we do not embrace all of the major reforms contained in the Final Report, we do share the same perceptions of the Staff that the provisions presently contained in Subchapter C are overly complex, inspire tax-motivated transactions, and often produce unfair and arbitrary results. If enacted into law, the

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2/ Standing Board Policy of the Florida Bar requires that positions of Committees, Sections or the Florida Bar be approved by the Board of Governors at a regularly scheduled meeting of the Board. The next scheduled meeting of the Board of Governors of the Florida Bar will be in November, 1985, which is subsequent to the required submission of this Statement. This Statement will be submitted at that meeting for Bar approval in accordance with the Standing Policies of the Board.

3/ "The Reform and Simplification Of The Income Taxation of Corporations",prepared by the Staff of the Senate Finance Committee, 98th Cong., 1st Sess., S. Prt. 98-95, (September 22, 1983) (hereinafter referred to as the "Preliminary Report").

proposed statutory amendments to Subchapter C will provide a more logical and consistent regime for taxing corporate transactions at both the corporate and shareholder levels and much needed uniformity to the loss carryover provisions.

In addition to engaging in a thorough and balanced reassessment of its earlier comments and positions in the Preliminary Report, the Staff provided specific statutory provisions in the Final Report designed to effectively implement the proposals. Although questions of a technical nature exist with respect to the meaning and scope of the proposed language in the draft of the bill, the Task Force's comments at this time are limited to addressing the general goals and policies of the proposals with a view towards discussing the particular subject areas with respect to which Chairman Packwood had requested comment. 4/

Recommendations for Corporate Acquisitions

In general, the Task Force endorses the basic goal of simplifying and improving our present labyrinth of statutory and judicial requirements governing corporate reorganizations. In particular, the Final Report's streamlined definition of a qualified acquisition, which is used to describe both certain asset and stock transactions, provides far more certainty of tax treatment in distinguishing a tax-free acquisition from a taxable sale. This much needed uniform definition of a qualified

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4/ Press Release. No. 85-056 (July 17, 1985).

acquisition stands in stark contrast to our present hyper-technical system of integrating the "alphabet soup" of reorganization patterns in Section 368(a) with the broad and uncertain scope of the judicially imposed continuity (shareholder interest and business enterprise) tests and business purpose doctrine in making the same determination. More critically, the present reality that permits essentially the same economic transactions to fall on opposite sides of a tax-free reorganization, or to raise critical overlap questions where the transaction fits more than one provision of the law, elevates matters of form over those of substance and creates the potential for abuse and uncertainty.

The Task Force's position is that the proposed system of express electivity is far more preferable than our current process of effective electivity in distinguishing a tax-free from a taxable acquisition.

The Task Force also endorses the Final Report's proposal permitting a purchasing corporation to simultaneously elect to step-up (or step-down) the target corporation's adjusted basis in its assets, and to elect carryover basis treatment for unamortizeable goodwill and similar intangible property. In a related context, we approve the Staff's proposal for computing a parent corporation's basis in stock of a controlled subsidiary based on the net aggregate basis of the subsidiary's assets (less the aggregate adjusted issue price of its liabilities) in avoiding double levels of taxable gain or loss for a single economic gain or loss. However, reform in this area can not ignore the presence of acquisition premium or discount. Although this problem area has been well defined, especially in the non-consolidated return context, there does not appear to be a single, satisfactory solution. We applaud, however, the Final Report's proposal of providing a three year window for reflecting acquisition premium or discount in stock basis in addressing the prompt resale fact pattern. This strikes a fair balance in resolving the tension between proper tax accounting and determination of economic income. 5/

As concerns the selectivity rules, if the General Utilities doctrine is totally repealed, as recommended in the Final Report, we perceive no need to require consistency in cost or carryover basis treatment other than on a entity wide basis as recommended. Although this should remove much of the complexity which currently plagues the rules under Section 338, which provides rules for treating certain stock acquisitions as asset purchases, 6/ the present recommendations may encourage the conduct of a single trade or business by separate subsidiaries. Still, the 24 month anti-avoidance rule contained in the bill will deny the opportunity for last minute maneuvers. We agree

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5/ See Proposals A2 and B2, American Law Institute, Federal Income Tax Project: Subchapter C (1982).

6/ See I.R.C. §§338(e), 338(f). Complex temporary regulations concerning the anti-selectivity rules to Section 338 were issued this year. T.D.8021, 50 Fed. Reg. 16402 (April 15, 1985).

with the analysis contained in the Preliminary Report that the complexities involved in applying a strict anti-selectivity rule on the one hand, or separate trade or business rule on the other, were less desirable than an entity-by-entity approach. As will be addressed below, we conditionally endorse the repeal of the General Utilities doctrine.

In the event that the General Utilities doctrine is substantially preserved in its present form, then, in passing the acquisition proposals, a group-wide consistency rule will be necessary.

The Final Report's non-linkage of the shareholder level consequences in a qualified acquisition to the corporate level consequences and to the tax treatment of other shareholders in the acquisition, represents a vast improvement from present law. We also endorse the Final Report's application of the investment company reorganization restriction at only the shareholder level and further support the rejection of the holding in the Shimberg case. 7/ The separate, two-level approach for analyzing the tax consequences to a qualified reorganization will not only remove cause for uncertainty among shareholders exchanging stock or securities for similar interests in an acquiring corporation, but will also remove the potential for unfair results, especially with respect to minority shareholders of the target corporation. 8/

7/ 577 F.2d 283 (5th Cir. 1978).

8/ May B. Kass v. Commissioner, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974).

Recommendations for Distributions

The Final Report recommends that generally any distribution of appreciated property by a corporation to a shareholder with respect to its stock be treated for tax purposes as if such asset were sold by the corporation to a third party for its fair market value. In contrast, current law permits a corporation in certain prescribed instances to make distributions to shareholders of appreciated property without triggering gain recognition at the corporate level. Such statutory exceptions are traceable to the Supreme Court's decision in General Utilities and Operating Company v. Helvering, 9/ and are commonly referred to as part of the General Utilities doctrine. As acknowledged in the Final Report, the General Utilities doctrine has gradually been eroded by legislative amendment to the distribution provisions contained in Sections 311 and 336.

The Task Force believes the General Utilities doctrine should be repealed but only upon the condition that substantial permanent relief be provided to closely held corporations which obviously stand to be adversely affected by this reform. 10/ Since we view the relief provided in the Final Report as inadequate, we cannot endorse the Staff's present proposal to repeal the General Utilities doctrine.

9/ 296 U.S.200 (1935).

10/ We strongly approve of the Final Report's dropping the proposed repeal of earnings and profits as a limit to taxing non-liquidating distributions to shareholders contained in the Preliminary Report.

In explaining our criticism of the proposal, we share the same concern of many others who have previously commented on this subject. The benefit of providing a logically consistent and simpler set of rules for corporate taxation facilitated by the repeal of the General Utilities doctrine does not outweigh the draconian impact that such repeal have on small and medium size businesses. 11/ Although we support a further partial repeal of the General Utilities doctrine with respect to FIFO inventory (LIFO inventory having already been repealed) and other non-capital assets, we are not in favor of adopting proposals which would have the present effect of taxing individual shareholders at a rate of 42.4% on the fair market value of capital assets and Section 1231 property long-held in corporate solution and distributed (or sold) in liquidation. Moreover, the proposals are unclear as to the treatment of goodwill and other intangible assets distributed in an in-kind liquidation. Thus, in addition to imposing a tax on largely inflationary gains on long term tangible assets, for which no distinction would be made as to pre-incorporation from post-incorporation appreciation, a forced corporate level tax on liquidation on the value of goodwill and other intangibles further reveals the harshness of the fall out resulting from this proposal.

11/ In this respect we are in agreement with much of the comment and analysis set forth in the ABA Section of Taxation Task Force Report, "Income Taxation of Corporations Making Distributions with Respect to Their Stock", 37 Tax Lawyer 625 (1984).

Until the full integration of corporate and shareholder level taxation becomes a reality, 12/ the abolition of the General Utilities doctrine will defeat the legitimate expectations of those who previously selected and currently operate their businesses in corporate form. In addition, it will create a strong bias in the future to avoid corporate solution altogether - a result which obviously has important economic and social implications. Furthermore, repeal of General Utilities will encourage small closely held businesses to merge with larger concerns in order to avoid a double tax on asset appreciation. We do not consider it desirable that the effect of the proposed changes in the tax law stimulate this type of acquisition activity.

Despite our rejection of the "liquidating bias" and "simplification" arguments set forth in the Final Report for repeal of General Utilities, we do agree with the argument that repeal is necessary in order to adopt the corporate acquisition reforms. There should not be a tax-free step up in basis at the corporate level while shareholders of a target corporation receive qualifying consideration. Therefore, because we endorse the reorganization proposals and recognize the need for repeal of General Utilities for its passage, a fair compromise to this problem must be reached by providing permanent shareholder relief. It is clear that in order to achieve the symmetry in Subchapter C for

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12/ See Treasury Department Tax Reform Proposals, Vol. II, at 134-44 (50% dividends paid deduction).

carryover and cost basis acquisitions, such relief should not be provided at the corporate level. In effect, this would only amount to a further partial repeal. We also consider the American Law Institute's credit proposal as overly complex and the suggestion related to the use and possible liberalization of Subchapter S as off the mark.

The Task Force endorses both the carryover basis liquidation and alternative shareholder level basis adjustment provisions prescribed in the Final Report as appropriate forms of relief from the repeal of General Utilities. We view the first relief provision, revised Section 333, as generally acceptable except that shareholder level taxation for liquidation distributions should be limited to the extent of cash and publicly-traded investment assets received and extended to non-publicly traded investment assets as currently set forth under the proposed statutory amendment. As to the second relief provision, an eligible shareholder will be permitted to increase his stock basis for corporate level net capital gains incurred by sale or distribution of long term property in the liquidation process. This effectively will limit the combined rate of tax on corporate capital gains to 28% (plus preference tax, if applicable) instead of 42.4%, to the extent such relief is available. Although we generally approve of this method of shareholder relief, the $1,000,000 limitation and phase out up to $2,000,000 in value as set forth in the Final Report is most inadequate.

The Task Force views that relief from General Utilities under the second alternative should not be made on the basis of the economic size of the corporation. We perceive no valid policy reason for penalizing corporations with greater amounts of untaxed appreciation in long-held business and investment assets. Although we could support the view that relief be provided for all capital gains (including gains from Section 1231 assets), such proposal would merely reformulate much of the General Utilities doctrine at the shareholder level. If there is to be a true narrowing of the doctrine even for capital assets, relief from double level capital gains tax should be provided to shareholders in closely held corporations which in many cases will consist of members of a single family unit. Accordingly, we propose that relief from the repeal of the General Utilities doctrine be extended to corporations whose shareholders meet the stock ownership requirement for personal holding companies, i.e., where 5 or fewer individuals, own, directly or indirectly, 50% or more of the outstanding shares of stock. In order to prevent possible abuse, stock ownership changes, e.g., purchases, redemptions, etc., within a certain period prior to liquidation (which could be the consistency period used for qualified acquisitions) would not be counted as qualifying stock. Since we recognize that certain small businesses may not meet the stock ownership requirement, we favor retention of the current proposed relief as a necessary back-up but with a greater dollar amount limit than currently proposed.

As set forth in the Final Report, the basis adjustment would only apply to capital assets and Section 1231 assets owned by the corporation. As to the holding period, we favor use of a 3 year period instead of the proposed 5 year period. A shorter period would soften the cost of disincorporating without over-extending the period that assets must remain in corporate solution. 13/

In summary, the Task Force rejects the Final Report's recommendation to repeal the General Utilities doctrine on the basis that the proposed shareholder relief provisions do not go far enough in protecting small and medium size businesses. In order for us to endorse this proposal, shareholder level relief from General Utilities under the stock basis adjustment method must extend to all closely held corporations regardless of economic size. We suggest that a closely held corporation for this purpose may be defined by reference to the stock ownership provision under the personal holding company rules. This form of shareholder level relief will avoid unfair and harsh results for shareholders of closely held corporations receiving distributions of appreciated, long-held, capital gain property while preserving the integrity of the acquisition proposals and removing much of the complexity of current law by the desired repeal of General Utilities at the corporate level.

13/ Support for a 3 year period may also be traced to the 3 year period used in Section 341(d)(3) in avoiding a finding of collapsibility.

Recommendations for Electing Subchapter S.

The Task Force believes that further study is required on the new proposal contained in the Final Report for imposing a double-tax on unrealized asset appreciation recognized by a former regular or Subchapter C corporation within a five year period after electing S status (or after an S corporation acquires the assets of a C corporation in a carryover basis, qualified asset acquisition) and distributed to its shareholders. Assuming the double-tax avoidance rationale behind the Staff's proposal were convincing, the proposed provision is overly complex and administratively burdensome. As to the rationale itself, we question whether the Staff's perception of potential abuse in this area is fully warranted. Although the subject is not directly addressed in the Final Report, it would be safe to assume that the repeal of the General Utilities doctrine would also apply to distributions in complete liquidation of an S corporations, even to an S corporation without a C corporation history. 14/ Furthermore, Subchapter S already contains a provision designed to prevent one-shot elections by C corporations for selling capital gains property. As to gains from the

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14/ Section 1363(d) provides that all distributions of appreciated property by an S corporation result in gain recognition at the corporate level. An exception to this rule applies to distributions in complete liquidation, Section 1363(e)(1), and distributions of qualified stock or securities in a reorganization, Section 1363(e)(2). See also Section 1371(a)(1), which provides that the rules in Subchapter C will generally apply to S corporations unless overriden by a provision in Subchapter S. The current draft of the bill does not directly repeal Section 1363(e)(1).

sale of non-capital assets and inventory, the maximum marginal rate of tax for individual shareholders, who are taxed on corporate level income under the conduit rules which govern Subchapter S, exceeds the maximum corporate rate.

Finally, the election under Subchapter S has never been treated as a realization event for federal income tax purposes. Instead, the Congressional intent in passing the Subchapter S provisions in 1958, and as recently revised, is to allow certain eligible corporations and their shareholders to use the corporate form for state law purposes without incurring a double-tax on profits. The Staff's present proposal, or any similar provision, which would convert a regular corporation's filing of an S election into a realization event, either on a current or deferred basis certainly would not only make Subchapter S less accessible to small business than it already is under current law, in light of the various eligibility restrictions, but is also inconsistent with previously expressed Congressional intent in this area. Thus, until specific problems are identified where the conversion of a C to S corporation creates the potential for wholesale abuse of Subchapter C, which would not otherwise be adequately covered under present law, and solutions to such abuses are proposed which are neither overly complex nor overbroad in their application, the Task Force can not endorse the findings contained in the Final Report concerning the use of S corporations.

Recommendations for Net Operating Losses

The Task Force endorses the provisions contained in the Final Report for net operating loss carryovers. There are four main benefits to be derived from the proposed reforms. First, the establishment of a single provision for all acquisitions is far more preferable than the awkward dichotomy between purchases and reorganizations under current law. Second, setting a ceiling for the future use of loss carryovers not only provides certainty as to the rate at which the loss may be absorbed, but will create a degree of uniformity not present under current law as to the value of an acquired corporation's carryovers. This should prevent trafficking in losses and establish a more neutral environment as to the relative importance loss carryovers are given in corporate acquisitions. Third, the use of loss carryovers will more properly be focused on the use of the losses as if there had been no change in ownership in the target. In contrast, the emphasis under the current rules linking the availability of loss carryovers to the continuation of the target's historic business or changes in stock ownership is misplaced. Further variations of the change in ownership emphasis are also presently contained in the SRLY and CRCO provisions in the consolidated return regulations. The Task Force endorses the position of the Staff that business and shareholder continuity should be irrelevant not only for qualified acquisitions, but also for loss carryovers as well. A fourth benefit under the proposal will be the inapplicability of present Section 269 to loss carryovers. This will remove the subjective element of tax avoidance motive from the analysis. Instead, the availability of loss carryovers will be determined by specific objective criteria.

For the above reasons, the Task Force views the proposed revisions in the Final Report to net operating losses as more desirable than both current law and the 1976 version of the carryover provisions. If the proposals are enacted, Section 269 should not apply to carryovers. Furthermore, the SRLY and CRCO rules under the consolidated return regulations should similarly be repealed since all corporations will have their losses limited under the objective rules of revised Section 382. The retention of additional stock ownership rules under the consolidated return regulations to further limit the use of loss carryovers serve no useful purpose and will only preserve the discontinuity between asset and stock acquisitions which the proposals are designed to completely remove.

As concerns the essential features of the proposed rules, the single purchase rule contained in the Final Report is much less complex, and, generally as equitable, as the "two-rule" approach previously contained in the Preliminary Report. The Task Force further approves of using the long-term AFR as the proper limitation based on the stated reinvestment rationale contained in the Final Report. Although we recognize that establishing a single absorption rate for all corporations and industries is inherently arbitrary and inaccurate,the simplicity of using a single rate is most desirable. However, any selected rate must be flexible enough to account for the possible turnaround of a loss corporation shortly after a change in ownership. Accordingly, and notwithstanding the actual "absorption rate" of loss carryovers by large U.S. corporations revealed in a recent report filed by the Staff of the Joint Committee on Taxation, the Task Force opposes use of any absorption rate less than the long-term AFR. Furthermore, we favor the treatment of recognized built-in gains and losses contained in the Final Report and believe that depreciation deductions attributable to a built-in loss at the time of the acquisition should be treated as recognized built-in losses for this purpose as is the rule under the consolidated return regulations. 15/

Under the Final Report, loss carryovers may not be acquired from an "investment company". With respect to this issue, the Task Force neither gives its endorsement or disapproval. On the one hand, it can be asserted that the effect of the recommendations in the Final Report on net operating losses in removing any business continuity requirement is inconsistent with the investment company restriction. In other words, it should not make any difference whether an acquired corporation converts its operating assets into an investment portfolio before or after a change in ownership in determining whether the acquiring corporation can

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15/ Treas. Reg.§1.1502-15(a)(2).

avail itself of the losses. On the other hand, the anti- trafficking rationale given in the Final Report for the invest- ment company limitation deserves substantial consideration.

Other Comments

In its Preliminary Report, the Staff recommended that publicly traded-limited partnerships be treated as corporations for federal income tax purposes. Subsequently, the Treasury Department recommended that all limited partnerships having more than 35 limited partners be classified as corporations. 16/ Although the Final Report did not address the matter for policy considerations, the Task Force would like to take this opportunity to acknowledge its opposition to any reform which would deny partnership treatment to publicly-traded or large limited partnerships that would otherwise be characterized as partnerships under existing rules and regulations. Certainly the passage of the proposals in the Final Report will increase the disparity between the taxation of corporations and partnerships. However, joint venturers should not be restricted from access to obtaining a single tax on entity level profits under the partnership model in Subchapter K, solely on the basis of the marketability of its interests or number of investors. Instead, the Task Force endorses the position that this issue should be resolved by further refinement of the corporate resemblance test in the regulations.

16/ Treasury Department Tax Reform Proposals, Vol.II, at 146-150.

The Task Force suggests that due to the magnitude of the proposed reforms contained in the Final Report and the present debate for general tax reform currently before the Congress, that the effective date of this bill be moved to taxable years beginning after December 31, 1986.

Statement

of

TAX EXECUTIVES INSTITUTE, INC.

on

The Subchapter C Revision Act of 1985

submitted in connection with
a September 30, 1985, hearing

of the

Subcommittee on Taxation and Debt Management
of the Committee on Finance

United States Senate

October 15, 1985

Introductory Comments

The taxation of corporations and their shareholders is one of the most complicated areas of the Internal Revenue Code and one that, without question, can be greatly simplified. As a professional association of corporate and other business executives, Tax Executives Institutes (TEI) is pleased to submit these comments on the May 1985 final report of the staff of the Committee on Finance on the proposed Subchapter C Revision Act of 1985. (The proposed legislation is set forth at pages 77 through 208 of the final report prepared by the staff of the Committee [S. Prt. 99-47, 99th Cong., 2d Sess. (May 1985)]. For convenience' sake, throughout this statement reference is made simply to "the report.")

Perhaps more than the members of any other professional group, members of TEI will be vitally affected by legislation fundamentally altering the way corporations and their shareholders are taxed. TEI is the principal association of corporate tax executives in North America. Its approximately 4,000 members work for more than 2,000 of the leading corporations in the United States and Canada and represent a broad cross-section of the business community in North America. TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws throughout the country, and to reducing the costs and burdens of administration and compliance to the mutual benefit of the government and taxpayers. We believe our diversity and the professional training of our members enable us to bring an important and balanced perspective to issues such as those raised by the staff's report -- we are the professionals who will have to interpret and comply with the results of the Congress's actions on a day-to-day basis.

When TEI testified on the staff's preliminary report on October 24, 1984, we urged the full Committee to move cautiously and deliberately in this area and to keep tax professionals and the business community fully apprised of its efforts to revise Subchapter C. We wish to commend the Committee and its staff for doing precisely that. By allowing adequate time for the affected individuals and businesses to review and reflect on both the preliminary and the revised proposals, the Committee has contributed significantly to improving the process by which the applicable rules are fashioned.

Before turning to our comments on the proposed bill as a whole and on specific provisions of it, we wish to make the following general observations:

1. Relationship to Tax Restructuring Proposals

We believe it is imperative that the Congress determine at a relative early stage precisely how the revision of Subchapter C relates to the ongoing efforts of Congress and the Administration to substantially restructure the tax system. Specifically, it must be determined whether the Subchapter C proposals should be kept completely separate from the general tax restructuring proposals, whether they should be considered in tandem with those proposals (and therefore included as part of a comprehensive tax bill), or whether further action on the Subchapter C proposals should be deferred until work on the restructuring proposals is substantially complete.

Tax Executives Institute believes that if a decision is made that the Subchapter C proposals should not be considered as part of the restructuring debate (a position the Administration seems to generally take judging from Assistant Treasury Secretary Ronald Pearlman's testimony on September 30), then it would be inadvisable to attempt to fashion final legislation concerning Subchapter C -- other than the provisions relating to the utilization of net operating loss carryovers (which require action by the end of the year) -- until any restructuring legislation is enacted.

We suggest this approach because it is clear that any restructuring bill passed by Congress will fundamentally affect corporations, their shareholders, and how business is conducted in the United States. Adequate time should be allowed not only to consider the technical ramifications of specific restructuring provisions on the staff's proposed Subchapter C changes, but also to determine how the policies underlying any restructuring legislation might be advanced (or undermined) by the proposed Subchapter C changes. For example, the Administration's tax proposals would advance the policy of integrating the corporate income tax and the individual income tax by allowing a partial dividends-paid deduction, whereas the staff's proposals would increase the likelihood of the double taxation of corporate earnings by, among other things, repealing outright the General Utilities doctrine. We recommend, therefore, that if Subchapter C reform is not integrated into the tax restructuring legislation now being fashioned, active consideration by the Committee of the staff's proposals (other than those relating to the treatment of net operating losses under sections 382 and 383) be deferred. At the same time, however, the staff should be encouraged to continue to work with all interested parties in refining its proposals.

2. Effective Dates and Transitions Rules -- The Role of Regulations

Given the complexity of corporate taxation and, of necessity, any legislative effort to substantially modify Subchapter C, it cannot be doubted that detailed, complex, and lengthy regulations will be necessary to implement the Congress's policy decisions concerning the proper tax treatment of corporations and their shareholders. Regrettably, there can also be little doubt that considerable time will pass from the enactment of legislation to the promulgation of regulations -- especially if the Treasury is simultaneously contending with regulation projects under any tax restructuring legislation. (Consider, in this regard, that more than three years have passed since section 338 of the Code was enacted and that taxpayers are still awaiting guidance on certain aspects of that section.) In the meantime, taxpayers -- in effect caught between the old and the new rules -- could have a difficult, if not impossible, time planning and conducting their business affairs.

In fashioning transition rules and determining effective dates for the Subchapter C proposals, we urge the Committee to keep in mind the need for clarifying, implementing regulations and the time that will be required to promulgate such rules. Specifically, we urge Congress to expressly provide that the legislative changes will be prospective. Moreover, in drafting flexible transition rules, we recommend that consideration be given to affording taxpayers the right to elect (within 180 days of the issuance of final regulations) to have prior law govern the tax consequences of particular transactions. Such an election -- coupled with transition rules that would allow taxpayers to "unwind" from certain transactions or relationships that they entered into in reliance on existing law -- would ensure that legitimate business transactions are not inhibited as the law evolves.

General Comments on Staff's Proposals

In perhaps no other area of federal taxation are the rules of income recognition so uncertain, complex, and inconsistent as they are in the area of taxation of corporations and their shareholders. The operative rules today are the result of statutory provisions enacted over a long period of years, judicial doctrines and judicially imposed requirements and tests, and a variety of Treasury and IRS rulings and regulations. It is in this context that the staff's proposals to revise and reform the provisions of Subchapter C of the Internal Revenue Code must be evaluated.

Tax Executives Institute generally supports (except for the proposed restrictions on the utilization of tax benefit carryforwards) the Committee's efforts to rationalize, simplify, and make certain the rules governing the taxation of corporations and their shareholders. This is not to say that we wholeheartedly endorse all of the staff's proposed changes. For example, we have serious reservations about the staff's proposal to repeal the General Utilities doctrine. We also believe that efforts to curb "trafficking" in tax benefit carryforwards must be moderated by considering the loss in value that might be suffered by minority shareholders and the artificiality of placing any limitations on a corporate taxpayer's reducing future year tax liabilities by current year losses or excess earned tax credits.

As a whole, however, the proposed Subchapter C Revision Act of 1985 represents a very good vehicle for ultimately developing a sound and well-reasoned replacement for the troublesome provisions of current law.

Beginning on page 9 of this statement, TEI provides its comments and suggestions regarding several of the staff's specific proposals. Before turning to specific provisions of the staff report, we wish to make three general comments.

First, we believe that the staff's supposition (expressed, for example, on page 59 of the report) that reform of Subchapter C hinges on the outright repeal of the General Utilities doctrine is improper. As stated above, TEI believes that the total repeal of the doctrine (especially with respect to complete liquidations) could produce harsh results affecting the shareholders of large, publicly held -- as well as small, privately held -- corporations. We believe the proposal, by increasing the situations in which there could be double taxation of corporations and their shareholders, would move the tax system in precisely the wrong direction.

We do not believe, moreover, that the goal of integration should be cast blithely aside in an effort to curb abuses -- or perceived abuses -- that might arise under current law. In this regard, the effect of the staff's proposal should be contrasted with the Administration's proposal to afford corporations a partial deduction for dividends paid.

Secondly, we believe that the staff's proposal to impose harsher rules on the shareholders of large, publicly held corporations than are imposed on shareholders of smaller, closely held companies is misguided and unrealistic. Specifically, the staff would limit relief from the proposed repeal of the General Utilities doctrine to shareholders of companies having a fair market value of $1 million or less. The staff offers no policy reason for so limiting the relief other than to state that providing relief to larger corporations would be complex.

We object to such a limited relief provision not only because the $1 million ceiling is at once arbitrary and unrealistically low, but because it seems to owe its existence to little more than a deeply flawed "big is bad" mindset. To ask the question -- why should relief be granted to the sole owner of a corporation with a fair market value of $1 million or less and denied to 100 shareholders who together own a corporation whose fair market value is $2 million? -- is to expose the weak underpinnings of the staff's proposal. In addition, in light of the fact that the stock of large, publicly held companies is held in large measure by institutional investors (including pension plans and mutual funds) that represent multitudes of small investors, we believe that the attempted distinction between "large" and "small" companies and their respective shareholders is inappropriate. We urge the Committee to modify the staff's proposals to ensure that they do not discriminate against shareholders of large, publicly held corporations.

Thirdly, we generally oppose the imposition of further limitations on a corporation's ability to transfer its losses. In this regard, we note as a preliminary matter that the proposal to further limit the transferability of tax benefit carryforwards is inconsistent with one of the goals of the staff's acquisition proposals -- to separate shareholder tax treatment from corporate tax treatment.

More fundamentally, we suggest that efforts to curb "trafficking" in tax benefit carryforwards should be tempered by two principles: first, that if the government is to be the partner of a business entity in good times (extracting a portion of the income), why should it not also share -- at least to the extent of limiting additional tax payments to the government -- the losses incurred by the business entity in bad times; and secondly, that the transfer of control of a company from one group of stockholders to another should not lead to the remaining minority shareholders' being unjustly deprived of the value inherent in the "target" corporation's tax benefit carryforwards.

Stated differently, we believe it is wrong to simply assume that so-called "trafficking" in loss carryforwards is bad. After all, such losses were dearly paid for by those companies that incurred them. It does not seem unconscionable that those companies should be able to reduce their economic losses by transferring the potential tax benefits to an acquiring company.

Consistent with these principles, TEI submits that absent a change of ownership permitting a single shareholder to hold 80 percent or more of the stock of a target corporation (thereby enabling it to file a consolidated return) and the target company's not continuing a principal business of the target company, there should be no reduction on the tax benefit carryforwards of the target corporation. This proposal, as well as our suggestions on how the limitation should be calculated where there is an 80 percent or greater change of control, is discussed in greater detail below.

Comments on Specific Staff Proposals

Definitions and Elections

Tax Executives Institute believes that the proposed adoption of uniform definitions regarding corporate mergers and acquisitions and the proposal to make the tax treatment of qualified acquisitions elective are the most desirable of the staff's proposed changes. We believe, moreover, that the definitional changes could well be adopted by themselves and that their enactment should not necessarily be tied to the staff's other proposals, including the proposed repeal of the General Utilities doctrine.

Specifically, proposed new section 364 would define "qualified acquisition" as meaning "qualified stock acquisition" or "qualified asset acquisition." Proposed new section 365 would treat all "qualified acquisitions" as "carryover basis acquisitions" unless an election were made to treat the acquisition as a "cost basis acquisition." As a result of the adoption of the uniform definitions, current section 368 would be repealed.

By establishing uniform definitions and making the tax consequences of qualified acquisitions elective, the staff proposal would eliminate some of the most significant flaws in the current system of taxation: the lack of consistent and certain tax treatment. Under the proposal, taxpayers would be permitted to structure the tax consequences of a transaction to the business realities of the particular situation, rather than structuring the business realities to the tax consequences.

In addition, the proposal would afford taxpayers the right to make separate cost-basis or carryover-basis elections with respect to each legal entity acquired in a given transaction (providing them much welcomed flexibility) and would obviate to a great extent the need to contend with the highly complex consistency rules of section 338. This new flexibility would be augmented by a taxpayer's right under the proposal to make separate carryover-basis elections within a given legal entity for certain unamortizable intangibles (such as goodwill).

Shareholder Level Tax Consequences

TEI also supports the proposed separation of the shareholder level tax consequences -- which would be determined on a shareholder-by-shareholder basis -- from the corporate level elections. Thus, under the staff's proposal, even if a transaction were treated as a cost-basis acquisition at the corporate level, it might be wholly or partially tax-free at the shareholder level, and the tax consequences to one shareholder would not affect the tax treatment of other shareholders or investors.

The staff's proposals in this regard would bring a much needed element of consistency and certainty to the area of corporate acquisitions and would make it considerably easier for businesses to adequately assess the tax implications to shareholders of contemplated corporate transactions. The need for such certainty can be made manifest by reference to two "real world" cases -- one involving the tax consequences to shareholders of AT&T upon the government mandated break-up of the company, and the second one involving the tax consequences to shareholders of Hartford Fire Insurance Company upon the acquisition of the company by International Telephone & Telegraph Corporation. (The tax implications to the shareholders of the AT&T break-up are still before the courts, and in the IT&T-

Hartford case, the chain of events leading up to IT&T's acquisition began in 1968 and the Service and the taxpayers did not reach an agreement on the proper tax treatment of the acquisition until 1981 -- more than a decade later.)

Section 351 Transactions

Under the staff's proposals, a transferor in a section 351 transaction would generally obtain a basis in any qualifying consideration received equal to the lesser of substitute basis or fair market value of the property transferred. TEI objects to this rule for two reasons.

First, the provision would require taxpayers to obtain appraisals of the property to be transferred in proposed section 351 transactions. These appraisals could be quite costly and by themselves would serve as an impediment to conducting business in the corporate form. The proposal thus seems at cross purposes with the overall goal of the staff's report, for it would complicate, not simplify, the decision whether to incorporate.

We believe it is inappropriate to force businesses to bear the additional (and otherwise unnecessary) costs of obtaining such appraisals where, for example, they decide to separately incorporate existing businesses that in the past had been operated as divisions of a single legal entity. Moreover, as stated above with respect to the definition of qualified asset acquisition, one thing is especially clear where a determination of "fair market value" is made: that determination could well be subject to challenge by the Internal Revenue Service on audit.

Our second objection to the proposed changes in section 351 is that, by providing that the transferor's basis will be the fair market value of the transferred assets if that value is less than the substitute basis, the proposal would require taxpayers in certain circumstances to lose a portion of their tax basis. Thus, the staff proposal would impose a toll charge on an entity's decision, made wholly for legitimate non-tax purposes, to conduct a business in the corporate form.

TEI believes that the transferor in a section 351 transaction should be permitted to acquire a substitute basis in the transferred assets. Such a rule would not only obviate the need to obtain costly (and potentially contentious) appraisals of all the assets transferred in the section 351 transaction, but would also serve to remove tax considerations from the decision whether or not to conduct a business in corporate solution.

Proposed Section 1020: Basis in Stock of Controlled Subsidiary

Under proposed new section 1020, the basis of a controlling corporate shareholder in the stock of a controlled subsidiary would generally be equal to the net inside basis of the assets of the subsidiary -- that is to say, the aggregate basis of the assets of the subsidiary reduced by the aggregate adjusted issue prices of the liabilities of the subsidiary. The amount by which the controlling corporate shareholder's basis in the stock of the controlled subsidiary (determined without regard to proposed new section 1020) exceeds (or is less than) the net inside basis of the subsidiary would be placed in a "premium account" (or a "discount account"). For a three-year period, the net inside basis of the subsidiary would be increased by any balance in a premium account and decreased by any balance in a discount account; after three years, the accounts would automatically become zero.

Although TEI recognizes the need for a consistent and simplified set of rules for determining the basis of stock in a controlled corporation, we object to the portion of proposed section 1020 that requires the mandatory retirement of premium or discount accounts after three years. The purpose of the "bullet" disappearance of excess stock basis or the effective step-up of stock with a basis less than that of the related inside assets is unclear to us. What _is_ clear, however, is the harsh results the provision would produce.

The automatic termination of a premium or discount account could, in many situations, deny taxpayers any meaningful choice with respect to the corporate level elections to be made in connection with a qualified stock acquisition. Specifically, the provision would have the effect of compelling a purchasing corporation to make an otherwise undesirable cost-basis election where a substantial premium was paid for the stock of the target corporation. If such a cost-basis election were not made, the acquiring corporation would face the prospect of a forced basis reduction for the stock of the subsidiary at the end of three years.

Such a Hobson's choice does not seem consistent with the stated aims of the staff's proposal (making the tax consequences of an acquisition elective with the taxpayer and eliminating any bias for or against asset acquisitions vis-a-vis stock acquisitions). Nor does the proposal, which could inhibit legitimate business transactions while encouraging a certain amount of "churning" (before the disappearance of the premium account at the end of the three-year period), seem to serve the overall goal of reducing the extent to which tax considerations govern how business transactions are structured or whether they are, in fact, consummated.

With respect to proposed section 1020, we refer to the example set forth at pages 54 and 55 of the staff's report. In that example, a corporation acquires all the stock of another corporation for $100 where the net inside basis of the acquired corporation (i.e., the basis of its assets) is $80. The stock of the target corporation is then sold the day after the acquisition for $100 in a transaction that generates no gain or loss, since the basis of the stock equals its section 1020 basis (i.e., the net inside basis of the target's assets) -- $80 -- plus the premium account -- $20 -- or a total of $100.

The staff's example, however, ends too soon. It does not consider the result where the sale of the stock does not occur until after the premium account "disappears." If, for example, the sale occurred more than three years after the acquisition, the acquiring corporation would recognize a taxable gain of $20 (the difference between the consideration received in the sale and the amount of its section 1020 basis) -- even though the terms of the sale would be identical to the sale discussed by the staff in its example.

Such a result is clearly inequitable and unjustified. We recommend, therefore, that proposed new section 1020 be amended to provide that a controlling shareholder will permanently retain its premium or discount accounts in a controlled subsidiary.

Proposed Repeal of the General Utilities Doctrine

In general, TEI continues to oppose any proposal that imposes a double tax on certain transactions between corporations and their shareholders -- specifically, distributions of appreciated property in liquidations. Thus, we believe that the staff's proposed repeal of the *General Utilities* doctrine, under which such distributions give rise to no tax at the corporate level, should be rejected.

We recognize that the application of the doctrine has been significantly limited by Congress in recent years (most recently, in the 1984 amendments to section 311(d)). Even if the current limitations manifest good tax policy (and we question whether they do), we would dispute whether further retrenchment is desirable. We believe good policy reasons exist for retaining (if not expanding) the *General Utilities* doctrine with respect to distributions of appreciated property in liquidations.

First, the doctrine serves the long-standing policy of limiting the double taxation of corporations and their shareholders. Adoption of the staff's recommendation to repeal the doctrine would run counter to this policy and would be inconsistent with the policy assumption underlying the Administration's proposal to accord corporations a partial dividends-paid deduction.

Secondly, repeal of the doctrine would make it costly for shareholders to "unwind" from the corporate form, which would not only adversely affect existing corporations but which could lead certain businesses not to incorporate even where, absent tax considerations, operating in corporate solution would be preferable. Thus, the staff's proposal would create a bias against the corporate form and undermine the principle of tax neutrality, one of the stated objectives of the proposed legislation.

As to the staff's argument that the General Utilities doctrine can lead to abuses and is a necessary adjunct to its more salutary and welcomed proposals, we must disagree. It has simply not been demonstrated that widespread abuses have occurred or that recently enacted changes to section 311(d) are not adequate to prevent any abuses that might occur. Moreover, it would seem relatively simple to provide that the doctrine would not be applicable where the liquidation in question is part of a qualified acquisition and a cost-basis election is made. In other words, the salutary definitional changes the staff proposes need not be held hostage to the outright repeal of the General Utilities doctrine.

Turning to the relief provisions the staff suggests with respect to the repeal of the General Utilities doctrine, we believe that if a decision is made to adopt the staff's general recommendation, it would be inappropriate to limit relief to the shareholders of certain small and generally closely held corporations. The staff would limit relief to shareholders of companies having a fair market value of $1 million or less. We suggest, however, that the concerns that led the staff to recommend relief for shareholders of small corporations also apply with respect to the shareholders of large, publicly held corporations.

As explained above (pages 7-8) in greater detail, there seems to be absolutely no sound policy reason for limiting relief to "small" corporations. Moreover, because the staff proposal would require a determination of a corporation's fair market value, liquidating corporations might have to incur the cost of an appraisal to determine whether they qualified for relief. If the taxpayer's $1 million-or-less appraisal were challenged on audit by the Service, however, the shareholders of a "not-quite-small-enough" corporation might find themselves faced with an unexpected tax.

The staff suggests (at page 63) that the cause of simplicity would be served by limiting relief to "a tightly circumscribed number of cases involving smaller corporations." We believe, however, that the staff's concern about the relief provision's complexity could be allayed by providing that a proportionate share of the total credit (reflecting the amount of the corporate level tax) would be allocated to all shareholders (regardless of the corporation's size) on a share-by-share basis.

In summary, we recommend that the relief provisions be extended so they apply to complete liquidations of all corporations regardless of their size.

Proposed Section 356(e): Treatment of Nonqualifying Consideration

TEI supports the special rules of proposed new section 356(e) that are designed to avoid double taxation at the corporate level where a controlling corporate shareholder received nonqualifying consideration in exchange for a target corporation's stock or assets. Under the staff's proposal, a controlling corporate shareholder receiving such consideration would not recognize any income if the acquiring corporation makes a cost-basis election with respect to the target corporation or where a carryover-basis election is made and the controlling corporate shareholder distributes the nonqualifying consideration to its shareholders or creditors within 12 months of the acquisition.

We also endorse the provision that would permit the target corporation to be treated as a member of a selling affiliated group with respect to gain or loss recognition in the case of a cost-basis election. This would be wholly consistent with the principles underlying section 338.

We must object, however, to the staff's proposal to aggregate the earnings and profits of both the target and the acquiring corporation for purposes of determining the extent to which the receipt of nonqualifying consideration by a target corporation shareholder will be treated as the receipt of a dividend. Under the proposal, the shareholder of the target corporation is treated as having received only the stock of a party to the acquisition, and then as having all or a portion of that stock redeemed (to the extent of the nonqualifying consideration received). Given this statutory scheme, it would seem more appropriate to take into account only the earnings and profits of the acquiring corporation.

Treatment of Tax Benefit Carryforwards

Unless Congress takes action by the end of the year, 1976 amendments to sections 382 and 383 (relating to limitations on net operating losses carryovers and other tax benefit carryforwards) will go into effect (for taxable years beginning after December 31, 1985). (The amendments were enacted as part of the Tax Reform Act of 1976, but their effective date has been postponed because of their extraordinary complexity.) Consequently, unlike the other changes proposed by the staff, the proposed revision of sections 382 and 383 (and the recommended enactment of new section 382A) requires immediate attention. We seriously question, however, whether the proposed changes are, in their current form, preferable to the pre-1976 rules (which are currently effective and which are hereinafter referred to as "the 1954 rules").

Under the staff's proposal, the use by a corporation each year of net operating loss carryovers and other tax benefit carryforwards after there has been a substantial change of ownership would be limited to an amount equal to the federal long-term rate under section 1274(d) times the value of the corporation at the time of the change. For purposes of this rule, the staff would define "substantial change in ownership" to mean any change -- whether effected by purchase, merger, asset acquisition, redemption, issuance of new stock, recapitalization, etc., or any combination of the foregoing -- resulting in a shift in ownership of the equity of the corporation of more than 50 percent. In determining whether a substantial change in ownership had occurred, transactions occurring within a three-year period prior to the change in ownership would be taken into account.

As stated above (on pages 8-9), Tax Executives Institute is philosophically opposed to the imposition of limitations on a corporation's ability to transfer its losses. First, we submit that such limitations are inconsistent with one of the principal thrusts of the staff's proposals -- to separate shareholder tax treatment from corporate tax treatment. Secondly, we believe that if the government is to be the partner of a business entity in good times (extracting a portion of the income), it should also share -- at least to the extent of limiting additional tax payments to the government -- the losses incurred by the business entity. Finally, we believe that such limitations could result in the minority shareholders' being unjustly deprived of the value inherent in the "target" corporation's tax benefit carryforwards upon the transfer of control of a company from another group of stockholders to an acquirer.

Recognizing that there may be a perceived need for some limitations on the transferability of tax benefit carryforwards, we nevertheless submit that the staff's proposals are far too stringent. In particular, we object to the proposed elimination of section 382(a), under which the limitations are not imposed unless there is no continuation of a historic trade or business of a target corporation and to the proposed imposition of a 50-percent control test.

We submit that the proposed percentage threshold is unrealistically low and that it ignores the very real fact that shareholders frequently are required to surrender "control" of their corporations in order to obtain the necessary infusion of capital necessary to turn an existing business around. It also disregards (almost cavalierly in our view) the diminution in real economic value that minority shareholders might suffer under the staff proposal, as a result of a partial shift in ownership over which they had no control.

To address the shortcomings of the staff proposal, we recommend that absent a change of ownership permitting a single shareholder to hold 80 percent or more of the stock of a target corporation (thereby enabling it to file a consolidated return) and the target company's not continuing a principal business, there should be no reduction of the tax benefit carryforwards of the target corporation. (We also recommend that, in determining whether the percentage/control test has been satisfied, a facts-and-circumstances test be substituted for the mechanical, three-year test the staff proposes.) Unless these changes were made in determining when the limitations on the use of tax benefit carryforwards will apply, we would conclude that the 1954 rules would be preferable to both those proposed by the staff and those enacted in 1976.

Turning now to the staff's specific proposed limitations, we note first that when TEI testified on the staff's preliminary report in 1983, we did not express a preference for either the proposed purchase rule or the proposed merger rule or whether we believed there should only be one such rule. We did, however, express concern over the potential application (under the proposed purchase rule) of a single rate of return to all companies in all industries, given the undeniable fact that companies and industries enjoy very different rates of return on their assets.

TEI now believes (as does the staff) that the adoption of a single rule is preferable to the two-rule approach set forth in the preliminary report. This would be consistent with the goal of treating asset acquisitions and stock acquisitions equally. Moreover, we believe that the proposed purchase rule would be considerably easier to apply than the proposed merger rule.

We continue to be concerned, however, about the application of a single rate of return to all taxpayers. Furthermore, should the Committee determine that the use of a single rate of return is appropriate (for simplicity' sake, if nothing else), we would recommend that a rate higher than the one proposed by the staff -- applicable long-term federal rate -- be used.

The section 1274(d) rate that the staff proposes be used is a debt rate, whereas the use of an equity rate of return would be much more reasonable. We note in this regard that when a company sells its assets, it usually does not reinvest the proceeds in conservative debt instruments (such as Treasury obligations). Rather, the proceeds are reinvested in the business, and that investment by its nature is considerably more speculative (and higher yielding) than an investment in long-term federal bonds.

There are several different, more realistic alternatives that could be employed. The ABA Section of Taxation's proposal to allow two percent of the carryforwards to be utilized each month for 60 months (for a total of 120 percent), for example, is based on an assumed equity pre-tax rate of return of approximately 20 percent (see September 30, 1985, Statement of Hugh Calkins, Chairman of the ABA Section of Taxation, Before the Senate Committee on Finance, at page 10). Using the average rate on fully taxable long-term corporate debt obligations, while not as favorable to taxpayers as the ABA proposal, would also yield a more efficacious result than the staff proposal.

Finally, we turn to the staff's proposals concerning built-in gains and losses (gains and losses that have economically accrued at the time of the change in control but that have not yet been realized). Under the staff proposal, losses attributable to the recognition of built-in losses would generally be subject to the same limitations as net operating loss carryforwards; any available net operating loss carryovers (or losses attributable to built-in losses) could be used, without limitation, to offset income attributable to the recognition of built-in gains after the change of control. The built-in gain and loss rules would only apply if the aggregate fair market value of the assets of the corporation exceeded 125 percent of the aggregate basis of such assets at the time of the change in control or was less than 75 percent of such aggregate basis.

We note at the outset that the proposed rules relating to built-in gains and losses are similar to the current rules under the consolidated return regulations. If the staff's proposed rules were adopted, we believe that all other rules limiting the use of tax benefit carryforwards should be repealed. The repealed rules would include not only the SRLY, CRCO, and built-in deduction rules under the consolidated return regulations, but also the subjective rules of section 269.

With respect to the built-in gain and loss rules, we must object to the staff's proposal to give the Treasury Department authority to issue regulations providing where those rules will be triggered even though the 125/75 test is not met. (Proposed new Code section 382(e)(4)(C).) The relative clarity of the 125/75 standard would be undermined by granting to the Treasury authority to broaden the scope of the built-in gain and loss rules. We also recommend that gains and losses, the recognition of which is subject to specific other provisions of the Code (such as those relating to depreciation deductions and the reserve for bad debts), not be subject to the proposal, since those items are not triggered by any overt action by the taxpayer.

Conclusion

If you should have any questions about this statement, please do not hesitate to call either Ralph Weiland, chairman of TEI's Federal Tax Committee, at (412) 562-4953; or Timothy J. McCormally, our Tax Counsel, at (703) 522-3535.

Respectfully submitted,

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